Supreme Court, U.S.
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No. _____

In The

Supreme Court of the United States

October Term, 1997

NORTHWESTERN INDIANA TELEPHONE COMPANY, ROBERT G. MUSSMAN, AND ESTATE OF MYRTIS MUSSMAN, Deceased, ROBERT G. MUSSMAN, Executor,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED FOR REVIEW

Whether the origin-of-the-claim test as set forth by this Court in the long-standing precedents of *United States v. Gilmore*, 372 U.S. 39 (1963) and *Woodward v. Commissioner*, 397 U.S. 572 (1970) permits an inquiry into a taxpayer's "motive" in determining whether attorneys fees are deductible under the Internal Revenue Code?

LIST OF PARTIES

The parties to the proceeding are as follows: The Petitioners are Northwestern Indiana Telephone Company, Robert G. Mussman, and Estate of Myrtis Mussman, Deceased, Robert G. Mussman, Executor. The Respondent is the Commissioner of Internal Revenue.

Pursuant to Supreme Court Rules 14.1(b) and 29.6, the following corporate listing is provided:

(i) List of all parent companies:

NITCO Holding Corporation

(parent of Northwestern Indiana Telephone Company).

(ii) List of all nonwholly owned subsidiaries:

None.

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PETITION FOR WRIT OF CERTIORARI

Petitioners respectfully pray that a writ of certiorari issue to review the judgments and opinion of the United States Court of Appeals for the Seventh Circuit entered on October 22, 1997. Petitioner's Petition for Rehearing and Suggestion for Rehearing En Banc was denied on January 7, 1998. The Seventh Circuit's opinion covered two judgments entered by the Seventh Circuit involving identical and closely related questions,[1] and pursuant to Supreme Court Rule 12.4, Petitioners herewith are filing a single petition for a writ of certiorari covering both judgments.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Seventh Circuit is reported at 127 F.3d 643 (1997), and is reprinted in the Appendix at App. 1-12.

The opinion of the United States Tax Court is reported at 1996 T.C. Memo 1996-168, and is reprinted in the Appendix at App. 13-117.

[1] That is, as recognized by the Seventh Circuit, the resolution of whether the attorneys' fees were deductible to NITCO necessarily resolves the issue of whether the attorneys' fees constituted constructive dividends to Robert Mussman and the Estate of Myrtis Mussman.

JURISDICTION

The United States Court of Appeals for the Seventh Circuit entered its judgment on October 22, 1997. Petitioners' Petition for Rehearing with Suggestion for Rehearing En Banc was denied on January 7, 1998. This petition is filed within 90 days of the date of the denial of petition for rehearing as allowed by 28 U.S.C. § 2101(c) and U.S. Supreme Court Rule 13.1. The jurisdiction of this Court to review the judgment of the United States Court of Appeals for the Seventh Circuit is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISION INVOLVED

26 U.S.C. § 162(a) provides in pertinent part:

> IN GENERAL – There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

STATEMENT OF THE CASE

The Seventh Circuit held that a telecommunications carrier could not deduct the attorneys' fees it incurred in defending, both in front of the Federal Communications Commission ("FCC") and later in court, allegations that its business activities violated federal regulations. The Seventh Circuit decided a question regarding the deductibility of attorneys' fees under the Internal Revenue Code

contrary to this Court's opinions in *United States v. Gilmore*, 372 U.S. 39 (1963) and *Woodward v. Commissioner*, 397 U.S. 572 (1970). Instead of examining the origin of the claim against the taxpayer, the Seventh Circuit instead relied almost exclusively on events occurring after the litigation had commenced or that were otherwise irrelevant to the lawsuit, and conducted a prohibited inquiry into the taxpayer's motive underlying the litigation.

In addition, by sustaining the denial of a deduction for attorneys' fees and the imposition of a constructive dividend, the Seventh Circuit created a direct conflict between itself and the Fourth Circuit Court of Appeal's decision in *Kopp's Co. v. United States*, 636 F.2d 59 (4th Cir. 1980) and the Tenth Circuit's decision in *Dolese v. United States*, 605 F.2d 1146 (10th Cir. 1979), *cert. denied*, 445 U.S. 961 (1980). The Seventh Circuit's inquiry into corporate motive to determine the deductibility of attorneys' fees has injected substantial uncertainty into the already complex field of corporate income taxation.

BASIS FOR FEDERAL JURISDICTION

The Tax Court had jurisdiction to hear the petitions in this case pursuant to 26 U.S.C. § 7442. The Seventh Circuit had jurisdiction over the appeal from the Tax Court pursuant to 28 U.S.C. §§ 1291 and 1294 and 26 U.S.C. § 7482.

BACKGROUND OF NITCO'S BUSINESS

Northwestern Indiana Telephone Company ("NITCO") is a closely held corporation having its principal office in Hebron, Indiana. The corporation is an independent telephone company providing local wire-based service to five small communities in rural northwestern Indiana.

During the taxable years here in issue, approximately 95% of NITCO's outstanding shares were held by Robert G. Mussman ("Mr. Mussman"). Mr. Mussman has a son named Rhys. At various times, Rhys has worked for NITCO either as an employee or under a consulting arrangement.

LITIGATION GIVING RISE TO ATTORNEYS' FEES IN ISSUE

After perceiving the inadequacy of cable service in the Hebron area, in April 1983 Rhys incorporated Northwestern Indiana CableVision ("NICATV"). NITCO had no direct ownership interest in NICATV.

In October 1983, Comark Cable Fund III ("Comark"), a cable company having no relationship with NITCO or NICATV, filed a complaint with the FCC alleging that NITCO and NICATV were affiliated companies engaged in anti-competitive conduct in violation of the Communications Act of 1934 and the FCC's telephone/cable cross-ownership rules. *See* 47 C.F.R. § 63.54. The complaint alleged that NITCO acted unlawfully by constructing cable facilities for NICATV, by leasing pole space to NICATV, and by refusing to lease pole space to Comark.

Comark also alleged that NITCO engaged in discriminatory and anticompetitive conduct by allegedly cutting Comark's underground cables and by accusing Comark of attaching its cables to NITCO's poles without permission. In its complaint, Comark sought a cease and desist order against NITCO and monetary damages.

In response to Comark's complaint, the FCC concluded that NITCO violated section 214(a) of the Communications Act and section 63.54 of the FCC's rules. As a result, the FCC ordered NITCO to divest any prohibited cable television facilities, to negotiate a settlement of Comark's damages claim, and to forfeit $20,000.[2] App. 121. Moreover, the FCC referred the matter to the Department of Justice. As a consequence of the original FCC litigation, NITCO subsequently defended a governmental enforcement action, and it initiated a First Amendment challenge to the FCC's telephone/cable cross-ownership rules. The provisions in issue were subsequently declared unconstitutional in litigation by other telephone companies. *See, e.g., Chesapeake and Potomac Tel. Co. v. United States*, 42 F.3d 181 (4th Cir. 1994), *cert. granted*, 515 U.S. 1157 (1995), *vacated and remanded sub nom.*, 516 U.S. 415 (1996).

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[2] On advice of counsel, NITCO did not pay the forfeiture in order to obtain a trial de novo on the underlying allegation.

OPINIONS BELOW

NITCO deducted the attorneys' fees arising out of the above actions as ordinary and necessary business expenses under section 162.[3]

The Tax Court, in purporting to apply the origin-of-the-claim test, held that NITCO's attorneys' fees were not deductible:

> [w]e conclude that the activities that NITCO engaged in with respect to NICATV were nonbusiness activities of NITCO. As the claim in the divestiture and enforcement actions arose in connection with these nonbusiness activities . . . [the fees] are not deductible under section 162 . . . Petitioners have further failed to establish that the constitutional challenge action arose in connection with or proximately resulted from a business activity of NITCO.

App. 84-85.

The Seventh Circuit affirmed the Tax Court's denial of the deduction under the "origin of the claim" test articulated by this Court in *United States v. Gilmore*, 372 U.S. 39 (1963). In so holding, the court pointed to various transactions between NITCO and NICATV, and held that the attorneys' fees were not business related but instead "had to do with" NITCO's gratuitous involvement with NICATV. The Seventh Circuit reasoned:

> We agree that the origin of the claim did not involve NITCO's profit-making activities; in

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[3] Unless otherwise indicated, all section references are to the Internal Revenue Code (title 26 U.S.C.) as in effect during the years in issue.

> fact, it had nothing to do with NITCO's profit-making activity. Rather, it had to do with Mussman's assistance, through NITCO, to Rhys's business venture . . . The fact that after the FCC got wind of what was going on NITCO was required to defend itself against a possible fine is really a consequence of its gratuitous action . . . [t]he claim in this case originated with the nonbusiness activity of underwriting Rhys.

App. 6. On January 7, 1998, the Seventh Circuit denied Petitioners' Petition for Rehearing with Suggestion for Rehearing En Banc.

ARGUMENT (Reasons for Allowance of the Writ)

THIS COURT SHOULD GRANT CERTIORARI TO CORRECT THE SEVENTH CIRCUIT'S FAILURE TO PROPERLY APPLY THE ORIGIN-OF-THE-CLAIM TEST.

I. The origin-of-the-claim test controls the deductibility of NITCO's attorneys' fees.

Section 162(a) allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business. As recognized by the Seventh Circuit, the origin-of-the-claim test controls the determination of whether the attorneys' fees at issue were "ordinary and necessary" expenses of NITCO.

In *United States v. Gilmore*, 372 U.S. 39 (1963), this Court adopted the origin-of-the-claim test for determining whether attorneys' fees arise in connection with or proximately result from a taxpayer's trade or business. In *Gilmore*, the taxpayer, an individual, incurred legal

expenses arising out of his divorce proceeding. The taxpayer argued that his overriding concern in the divorce litigation was to protect his interests in three corporations against the claims of his wife. Thus, the taxpayer argued, the legal expenses were not nondeductible "personal or family" expenses, but rather, were expenses "incurred . . . for the . . . conservation of property held for the production of income" under the predecessor to section 212.

The Court rejected the taxpayer's argument and held that the expenses were nondeductible personal expenses because they stemmed from the marital relationship, stating:

> the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences on the fortunes of the taxpayer, is the controlling basic test of whether the expense was 'business' or 'personal' and hence whether it is deductible or not . . .

Id. at 49. In surveying its prior case law, the court noted its prior consistent statement in *Kornhauser v. United States*, 276 U.S. 145 (1928), where the Court explained, "where a suit or action against a taxpayer is directly connected with, or . . . *proximately resulted from*, his business, the expense incurred is a business expense. . . . " 276 U.S. at 153 (emphasis added).

In a later case, this Court further clarified the origin-of-the-claim test by holding that the taxpayer's "motive" or "purpose" is not relevant to the inquiry. In *Woodward v. Commissioner*, 397 U.S. 572 (1970), a taxpayer, who controlled a majority of a corporation's stock, voted for a

perpetual extension of the corporation's charter and was therefore forced under state law to purchase the minority interest at the "real value" of the minority's stock.

When the parties could not agree on the value of the shares, litigation ensued. As a result, the taxpayer incurred attorneys', accounting, and appraisal expenses. The taxpayer attempted to claim a current tax deduction for these expenses; however, the IRS disagreed and claimed that the expenses should have been capitalized as part of the cost of the acquired stock.

The taxpayer argued that the so-called "primary purpose" test should control whether the litigation expenses were deductible. Under this test, the taxpayer argued, it could deduct the litigation expenses because the primary purpose of the litigation was not to determine the title to the stock, which all agreed was to pass to the taxpayer, but rather to determine the value of the stock.

The Supreme Court rejected the taxpayer's argument and held that the "uncertain and difficult" primary purpose test should not control the outcome, but rather, the question should be resolved by the simpler inquiry into whether the origin-of-the-claim was in the process of acquisition itself. *Id.* at 577. The Court reasoned that:

> A test based on the taxpayer's 'purpose' in undertaking or defending a particular piece of litigation would encourage resort to formalisms and artificial distinctions.

Id. at 577-78. Further, the Court explained that a standard based on the origin-of-the-claim comports with *Gilmore*, where "[t]he Court rejected a test that looked to the consequences of the litigation, and did not even examine

the taxpayer's motives or purposes in undertaking defense of the litigation, but rather examined the origin and character of the claim against the taxpayer." *Id.* at 578.

Thus, *Gilmore* and *Woodward* together demonstrate that the controlling factor under the origin-of-the-claim test is the nature of the transactions or process giving rise to the litigation. This question must be answered unmuddled by the uncertain and difficult inquisition into the vagaries of a taxpayer's motives or purpose.

Indeed, the Seventh Circuit, in *Anchor Coupling Co. v. United States*, 427 F.2d 429 (7th Cir. 1970), *cert. denied*, 401 U.S. 908 (1971), has itself recognized the dangers of examining a taxpayer's motive in an origin-of-the-claim analysis:

> Consideration of the taxpayer's motive and the consequences of his failure to make [the settlement payment at issue] create the same problems . . . For the deductibility of payments to depend on such elusive determinations causes tremendous difficulties for the administration of the tax laws . . . for deductibility to depend on such subjective considerations encourages schemes of tax avoidance and . . . can lead to capricious results.

Id. at 433. *See also Newark Morning Ledger v. United States*, 539 F.2d 929, 935 (3d Cir. 1976) ("Intent or motive is irrelevant under the 'origin of the claim' test").

Thus, when applying the origin-of-the-claim test, a taxpayer's motive is simply not part of the equation. Instead, the court must consider the issues, the nature and objective of the litigation, the defenses asserted, and

"all facts pertaining to the entire controversy out of which the disputed expenses arose." *Estate of Morgan v. Commissioner*, 332 F.2d 144, 151 (5th Cir. 1964).[4]

Here, the Seventh Circuit's decision failed to undertake an objective analysis of the transactions that gave rise to the litigation. Instead, the court's opinion turned on its improper examination of events occurring *subsequent* to the commencement of the litigation or that were otherwise irrelevant to the claims against NITCO, and on an improper examination of NITCO's *motive* for entering into the transactions that gave rise to the litigation.

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[4] Indeed, the Tax Court has acknowledged that attorneys' fees associated with the defense of an FCC proceeding are "ordinary and necessary" expenses. *BHA Enterprises, Inc. v. Commissioner*, 74 T.C. 593 (1980). The legal expenses in issue were incurred by a radio station in connection with an FCC proceeding to revoke its broadcasting license. Because a revocation would have precluded any broadcasting activity, it was undisputed that the expenses were proximately related to the broadcaster's business. The court held that the fees did not have to be capitalized, but instead were deductible under section 162:

> the gravamen of the case before us was the FCC's complaint against petitioner about the way it was observing – or failing to observe – the FCC's rules, plus various other alleged business abuses. Thus, the 'claim litigated' was in no way related to the process of acquisition *but rather developed solely as a result of petitioner's business activities.*

Id. at 600 (emphasis added).

II. The Seventh Circuit acted contrary to the decisions of this Court by resting its decision on a finding of NITCO's gratuitous motive.

This Court has wisely rejected an inquiry into a taxpayer's motive as a proper component of the origin-of-the-claim test. *Woodward*, 397 U.S. at 577-78. However, the Seventh Circuit's inquiry into events that occurred after the FCC litigation had begun, and events which had nothing to do with the origin of the claim, demonstrates that the court rested its holding on a prohibited analysis of NITCO's motive, rather than on a proper analysis of the origin of the *claim* underlying the litigation.

The Seventh Circuit's interest in NITCO's motive is clear. For example, the court stated that "[t]he fact that after the FCC got wind of what was going on NITCO was required to defend itself against a possible fine is really a consequence of its *gratuitous* action . . . [t]he claim in this case originated with the nonbusiness activity of underwriting [the son of NITCO's main shareholder]." App. 6-7 (emphasis added). Further, the court found that NITCO's "involvement" with NICATV was "far from being profit-driven," but instead that NITCO "subsidized [NICATV] in a variety of ways." The court's exploration and characterization of various "nonbusiness" transactions demonstrates a clear inquiry into NITCO's motive for its involvement with NICATV.

However, this Court's precedent as well as precedent of lower courts have long recognized that inquiry into a taxpayer's motives is prohibited in analyzing the "origin-of-the-claim." The court's exploration of NITCO's reasons for entering into various transactions the court deemed

relevant is precisely the type of subjective and treacherous inquiry that this Court has prohibited.

Under the Seventh Circuit's analysis, because NITCO's *motives* for entering into the transactions the court found relevant were to subsidize NICATV, NITCO's expenses in defending itself against the FCC were not corporate expenses. Following this reasoning, if a telecommunications carrier's *motive* in violating FCC rules was to benefit a shareholder personally, then, according to the court, the associated attorneys' fees are nondeductible. However, if the carrier's *motive* in violating the FCC rules was something else, be it for anti-competitive reasons, corporate greed, or any other "business" motive which the taxpayer can proffer, then the fees will be deductible. Courts should be slow to attribute to Congress a purpose producing such an unequal treatment among taxpayers, resting on no rational foundation. *See Gilmore*, 372 U.S. at 48.

Further, the Seventh Circuit's analysis of motive here is particularly troubling because the taxpayer is a corporation, rather than an individual. If the Seventh Circuit's opinion stands, it will now be necessary to undertake a subjective inquiry into the vagaries of corporate motive to determine whether corporate attorneys' fees are deductible.

III. After erring once by examining NITCO's motives, the Seventh Circuit erred again by focusing on transactions that were either irrelevant to the origin-of-the-claim or that occurred after the commencement of the litigation.

A fundamental premise of the origin-of-the-claim test articulated by this Court is that the origin and nature of the claims against a taxpayer, and of the transactions giving rise to those claims, determines whether the litigation is proximately related to the taxpayer's trade or business. Thus, the question here properly is: What transactions triggered Comark's suit against NITCO?

Surely the best place to begin is with the complaint Comark filed with the FCC, which alleged several incidents. *See* App. 121 (describing complaint). The first category of transactions complained of by Comark arose out of NITCO's dealings with Comark itself. For example, Comark complained of NITCO's alleged refusal to enter into suitable pole attachment agreements with Comark, NITCO's alleged cutting of Comark's cables, and counter allegations by NITCO that Comark was attaching to poles without permission. The other category of transactions that Comark complained of arose out of NITCO's dealings with NICATV. These included NITCO's leasing of telephone pole space to NICATV, and NITCO's construction activities on behalf of NICATV. These were recognized business activities of telephone companies. *See Northwestern Indiana Telephone Co., Inc. v. FCC*, 824 F.2d 1205, 1207 (D.C. Cir. 1987).

In sum, Comark, and ultimately the FCC, objected to the way NITCO – a telecommunications carrier falling under the jurisdiction of the FCC – was observing, or

failing to observe, the FCC's rules while operating its business. The assets involved in the transactions that gave rise to the suit – NITCO's telephone poles, its office space, and its construction personnel – were all economically integrated with NITCO's primary business activity of operating as a telecommunications carrier.

Further, a telecommunications carrier's choice as to the use of its business assets, who it enters into pole attachment agreements with, the terms of such agreements, its use of office space, its interpretation of FCC rules, and, candidly, its decision about the persons or entities with whom it will (or will not) do business, all relate to the primary business activity of the carrier. Indeed, as the D.C. Circuit Court of Appeals later recognized, the FCC's rules *required* that a telephone company lease space to a cable operator in certain circumstances. *Northwestern Indiana Telephone Co*, 824 F.2d at 1209. *See also* 47 U.S.C. § 224 (1983).

What is troubling about the Seventh Circuit's analysis is its almost exclusive reliance on events occurring *after* the FCC litigation had commenced to characterize the *origin* of that very litigation by examining NITCO's motives. The Seventh Circuit cited no authority that would allow this revolutionary extension of the origin-of-the-claim test.

The FCC complaint was filed against NITCO in 1983. Clearly, only transactions occurring before this time could have formed the "origin" of the claim against NITCO. However, to support its analysis, the Seventh Circuit relied on the fact that NITCO paid NICATV's utility bills *in 1988 and 1989* (over 5 years after the FCC complaint

was filed), and that NITCO wrote off $122,000 owed by NICATV to NITCO[5] some five years after the complaint was filed. Further, the Seventh Circuit found it significant that a contract addressing NICATV's use of NITCO's poles and offices allegedly came into existence only *after* the FCC complaint was filed and after the FCC order was entered. App. 6.

After its misguided inquisition into these subsequent events, the Seventh Circuit then concluded that NITCO's "gratuitous action" had caused the already begun litigation. This conclusion is most puzzling. Regardless of whether the events relied on so heavily by the Seventh Circuit could be characterized as gratuitous, they were *not* the transactions triggering the litigation which the Seventh Circuit was called to address. Comark had no quarrel with NITCO's payment of NICATV's utility bills, NITCO's forgiveness of a debt owed by NICATV, or whether NITCO's pole and office sharing agreements with NICATV were actually reduced to writing. These transactions – relied on so heavily by the Seventh Circuit – had nothing to do with the origin of Comark's claim.

Subsumed by its inquisition into subsequent events to buttress its finding of NITCO's gratuitous motive, the Seventh Circuit ignored the transactions that actually gave rise to the litigation. Indeed, the primary group of transactions giving rise to Comark's claim, that is, those transactions between Comark itself (an unrelated party)

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[5] This amount represented the remaining balance of NITCO's accounts receivable relating to NICATV.

and NITCO, were completely ignored by the Seventh Circuit.

The essence of the Seventh Circuit's analysis is clear. By painting a landscape of enough other "nonbusiness" transactions – transactions that had nothing to do with Comark's claim against NITCO and transactions that for the most part occurred after Comark's complaint was filed – the Seventh Circuit felt that a sufficiently dark cloud was cast over NITCO's motives to render unnecessary a substantive analysis of the transactions and claims which gave rise to the litigation in issue. This should not be permitted.

The Seventh Circuit was called to address the deductibility of specific attorneys' fees through a proper application of the origin-of-the-claim test as articulated by this Court. Whatever the Seventh Circuit's opinion of "how far the concept of a business purpose can be pushed in the Internal Revenue Code," it was not entitled to disregard the precedent of this Court which holds that "the origin and nature of the *claim*" against a taxpayer determines the deductibility of the attorneys' fees associated therewith.

IV. As a result of the Seventh Circuit's incorrect application of the origin-of-the-claim test, the Seventh Circuit has created a direct and irreconcilable conflict between itself and the Fourth and Tenth Circuits.

Issuance of a writ of certiorari is compelling here because the Seventh Circuit's decision in this case creates a direct conflict between the Seventh Circuit and the

Fourth and Tenth Circuits. Both of the decisions, discussed below, were brought to the attention of the Seventh Circuit by the Petitioners.

In *Kopp's Co., Inc. v. United States*, 636 F.2d 59 (4th Cir. 1980), while making *personal* and permissive use of a car owned by a corporation, the son of the two shareholders was engaged in an automobile accident. *Id.* at 60. The injured party filed a lawsuit against the corporation, the shareholders, who were husband and wife, and the son.

Reversing the District Court, the Fourth Circuit allowed the corporation to deduct the settlement costs and legal fees incurred in defending in the litigation. The Fourth Circuit held that the "origin of the claim" doctrine established in *Gilmore* did not bar the corporation's deduction of the litigation expenses, stating that:

> The claim [against the Corporation] here, however, was not merely a personal claim only tangentially threatening to corporate assets. On the contrary, and importantly, [the plaintiff] named the Company as a party defendant to his suit, thereby directly bringing the business into the litigation and jeopardizing its assets . . . we see the Company's *direct* exposure to the risk of a monetary judgment significant in distinguishing the instant litigation from that of Gilmore.

Id. at 61 (emphasis in original). That is, even though the transaction triggering the lawsuit was the son's use of the corporation's car for noncorporate purposes, the involvement of the *corporation's asset* in the transaction giving rise to the litigation and the corporation's *direct* exposure to the risk of judgment rendered the attorneys' fees deductible.

In *Dolese v. United States*, 605 F.2d 1146 (10th Cir. 1979), *cert. denied*, 445 U.S. 961 (1980), a wife, pursuant to a divorce action, obtained an order against three corporations owned by her husband restraining them from undertaking certain actions without the permission of the court. The Tenth Circuit stated that, "the presence of the corporations as involuntary parties to the litigation, restrained by order from undertaking certain actions without permission of the court, presents a distinction from Gilmore which we believe is significant." *Id.* at 1151. The Tenth Circuit allowed the corporations to deduct certain legal expenses, stating:

> Once the corporation was inhibited from the conduct of profit-making activities by fear of violating the court order . . . the [litigation] costs . . . would seem to originate in its business activities. Therefore, to the extent a corporation incurred legal expenses in preparing pleadings to be filed in this litigation . . . the expenses are deductible.

Id. at 1151-52. Thus, even though, but for the divorce, the corporations would not have incurred any of the legal expenses at issue, the Tenth Circuit held that legal fees were deductible by the corporations. That is, the possible impact of the lawsuit on the *operations* of the corporation severed the causal chain between the personal divorce action and the deductibility of the attorneys' fees.

The conflict between the Seventh Circuit's decision here and both the Fourth Circuit's decision in *Kopp's* and the Tenth Circuit's decision in *Dolese* could not be more clear or direct. These cases establish that even if an indisputably nonbusiness event was in some sense the remote

cause of litigation faced by a corporation, the corporation's attorneys' fees are nonetheless deductible business expenses if the business assets of the corporation are involved in the underlying claim, the corporation is named as a defendant, and the corporation could face significant limitations on the conduct of its business as a result of the litigation.

Thus, even if the Seventh Circuit correctly relied on NITCO's gratuitous motive as the initial cause of the litigation, the court improperly held that NITCO could not deduct the attorneys' fees arising therefrom. Here, like the situation presented collectively by *Kopp's* and *Dolese*, NITCO was named as a defendant in the FCC litigation, it was the use of NITCO's business assets and NITCO's business activities which gave rise to the litigation, and as a result of the suit, NITCO faced significant limitations on the way it could conduct its business.

Indeed, the instant case is much more favorable to the taxpayer than the situations in *Kopp's* and *Dolese*; the Seventh Circuit easily could have avoided creating a split among the circuits. Here, the underlying claim is an FCC complaint alleging regulatory violations, and subsequent court litigation arising therefrom. This claim has infinitely more of a business-origin than the divorce action present in *Dolese* or the personal use of a company auto present in *Kopp's*. While the remote events triggering the litigation in *Dolese* and *Kopp's* were indisputably nonbusiness in nature, here, the transactions giving rise to the claims against NITCO were *business*-related. It was the Seventh Circuit's improper analysis of NITCO's motives that let the court to conclude otherwise.

V. The Seventh Circuit's erroneous examination of NITCO's motive spawned its fallacious chain of events inquiry, which concluded that "but for" NITCO's alleged gratuitous motives, the FCC litigation would not have occurred.

As a matter of simple logic, the "origin-of-the-claim" rule does not contemplate an illusory attempt to pinpoint the first in the chain of the events that gave rise to the litigation. Rather, the test requires an examination of all the facts. *See, e.g., Boagni v. Commissioner*, 59 T.C. 708, 713 (1973).

Here, the Seventh Circuit's opinion overlooks the most direct and proximate cause of NITCO's litigation with the FCC: the complaint brought against NITCO about the way it was observing, or failing to observe, the FCC rules, stemming from NITCO's use of its business assets, its choice of business associates, and its interpretation of the FCC's rules. Rather, the court embarked upon a journey down the winding trail of remote and multiple causations to conclude that, instead, NITCO's gratuitous *motive* caused the attorneys' fees in issue. That is, it was NITCO's gratuitous motive that caused NITCO to engage in the "non-arm's length" transactions with NICATV, the transactions triggered a violation of the FCC's rules, a complaint was brought in front of the FCC, and finally, NITCO incurred attorneys' fees in litigating the complaint and related actions. Thus, the Court reasoned, NITCO's gratuitous motive surely must have caused the attorneys' fees.

However, such logic is improper in an "origin-of-the-claim" analysis. Here, it is just as possible to use the

Seventh Circuit's logic to "prove" that NITCO's attorneys' fees were caused by having babies (i.e., Rhys Mussman). Why is it not just as clear that the cause of the litigation was NITCO's desire, as found by the FCC, to compete with Comark in the cable TV business? Why is it not just as clear that the cause of the litigation was Comark's desire to compete with NICATV? Even less defensible is the Seventh Circuit's refusal to consider NITCO's dealings with Comark (an unrelated company) as a causal factor giving rise to the litigation.

Indeed, it was the court's improper inquiry into NITCO's motives that lured the court into the conceptual snake pit of causation in the first place. An examination of the transactions that caused NITCO to be sued, unmuddled by an inquiry into the vagaries of corporate motive, compels the conclusion that the origin of the attorneys' fees was in NITCO's trade or business.

VI. The Seventh Circuit incorrectly considered only the purported "origin" of the claim, but ignored the "character" of the claim, as is required by this Court.

The Seventh Circuit also erred because it failed to consider the character of the FCC litigation. *Gilmore* teaches that the "origin *and character* of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was 'business' or 'personal'." *Gilmore*, 372 U.S. at 49 (emphasis added). Here, in its journey down the path of

multiple causations to determine the "origin" of the litigation, the Seventh Circuit completely failed to consider the *character* of the claim that NITCO litigated. In *Gilmore*, the "character" of the claim was a divorce action, a quintessentially personal matter. Here, the "character" of the claim was a formal complaint before a federal regulatory agency, and a subsequent agency enforcement action, alleging unlawful business activities. To argue that the quintessential character of this claim is not business related strains credulity.

CONCLUSION

For the reasons set forth above, certiorari should issue to the Court of Appeals for the Seventh Circuit so that this Honorable Court may review and correct the decision below.

Respectfully submitted,

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Attorney for Petitioner

In the

United States Court of Appeals

for the Seventh Circuit

No. 97-1021

NORTHWESTERN INDIANA TELEPHONE COMPANY,

Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

No. 97-1056

ROBERT G. MUSSMAN and ESTATE OF MYRTIS MUSSMAN, Deceased, ROBERT G. MUSSMAN, Executor,

Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appeals from Decisons of the United States Tax Court
Nos. 7970-91 and 7971-91

ARGUED SEPTEMBER 3, 1997 – DECIDED OCTOBER 22, 1997

Before COFFEY, CUMMINGS, and EVANS, *Circuit Judges.*

EVANS, *Circuit Judge.* These consolidated cases involve a difference of opinion between the Commissioner of the Internal Revenue Service and certain taxpayers about

how far the concept of a business purpose can be pushed in the Internal Revenue Code. The two issues in the cases are otherwise unrelated tax questions and arise out of the conclusions of the Tax Court: first, that certain litigation fees Northwestern Indiana Telephone Company, or NITCO, expended in cases arising out of an FCC action were not deductible as ordinary and necessary business expenses, but rather were constructive dividends to NITCO's controlling shareholder, Robert Mussman; and second, that NITCO's accumulated earnings and profits were not related to the reasonable needs of its business and were thus subject to the accumulated earnings tax.

After receiving deficiency notices, NITCO as well as Robert and Myrtis Mussman filed petitions in the Tax Court. The cases were consolidated, and following a 7-day trial the Tax Court issued a lengthy decision upholding deficiencies asserted by the Commissioner for tax years 1987, 1988, and 1989 against NITCO, Robert Mussman, and the estate of his wife Myrtis. The factual findings of the Tax Court will, of course, not be disturbed unless they are clearly erroneous. *Pelton Steel Casting Co. v. Commissioner*, 251 F.2d 278 (7th Cir. 1958), *cert. denied*, 356 U.S. 958.

NITCO, a closely held corporation in Hebron, Indiana, is an independent telephone company providing local service to five small communities in rural northwestern Indiana. Mr. Mussman owns 95 percent of the stock in NITCO and his brother owns the other 5 percent. In fact, the Mussman family has owned the company for 50 years, and for a good portion of that time the company was not especially lucrative – its 1951 net income, for example, was only about $9,800. However, after Interstate

65, the roadway that runs from Gary, Indiana, through the midsection of the Hoosier State to Louisville, Kentucky, was completed, the population the company served increased; more importantly, the breakup of AT&T added to its revenues. NITCO's annual revenue in 1987 exceeded $5 million. By 1989 NITCO had 8,634 access lines, but even then only 16 were multiline business customers. For 40 years – 1954 through 1994 – NITCO did not declare a dividend. Even when the company became more profitable, however, the earnings were not distributed, and as a result, NITCO's earnings and profits began to pile up, from $3,929,694 in 1983 to $15,250,005 a decade later in 1993.

Robert Mussman's two sons – Kyle and Rhys – have at times been employed by NITCO, and at other times both pursued their own business ventures. Kyle was involved primarily in cellular phone businesses and Rhys was involved in a cable television company. It is Rhys' activities which have primary relevance to the first issue before us.

In April 1983 Rhys incorporated NICATV (Northwestern Indiana CableVision) to provide cable service in rural northwest Indiana, including to some towns served by NITCO. Rhys was NICATV's president and sole stockholder. NITCO had no interest in NICATV but subsidized the company in a variety of ways, which we will mention in a moment.

In October 1983 Comark Cable Fund III, a competitor of NICATV, filed a complaint with the FCC alleging that NICATV and NITCO were affiliated companies engaged

in anticompetitive conduct in violation of the Communications Act. During the relevant time, FCC rules prohibited a local telephone company from offering cable television services within its telephone service area. The FCC rules said "affiliation" means any financial or business relationship whatsoever between a telephone carrier and a cable system, and affiliation of this sort is forbidden. In regard to Comark's complaint, the FCC concluded that § 214(a) of the Communications Act was violated, and NITCO and NICATV were ordered to divest themselves of the cable television facilities and to negotiate a good-faith settlement with Comark. NITCO was fined $20,000. Ultimately the FCC orders were upheld on appeal to the Court of Appeals for the District of Columbia Circuit. The Supreme Court denied a petition for certiorari.

NITCO and NICATV refused to comply with the FCC orders during the appeal process even though the court of appeals denied a stay. Therefore, the government brought an enforcement action in the District Court for the Northern District of Indiana, and meanwhile, in that same court, NITCO and Rhys brought a separate action alleging constitutional violations.

All of this litigation, of course, resulted in substantial fees. NITCO deducted fees in excess of $700,000 paid to the various attorneys as business expenses. The Commissioner disallowed the deductions and the Tax Court sided with the Commissioner.

Title 26, U.S.C. § 162, allows a deduction for "all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."

But the taxpayer has the burden of showing that the expense was both "necessary" and "ordinary." The burden is a real one because deductions are "a matter of legislative grace." *INDOPCO, Inc. v. Commissioner,* 503 U.S. 79 (1992); *A.E. Staley Mfg. Co. v. Commissioner,* 119 F.3d 482 (7th Cir. 1997). Although often the determination which must be made is whether the item is deductible as an expense or whether it is a capital expenditure, in this case the issue is whether it is a business expense or a personal expenditure. The Tax Court concluded that it was a personal expenditure and said, "[B]efore, during, and after the years in issue, NITCO engaged in extensive nonbusiness-related activities to benefit and support Mr. Mussman's sons."

NITCO contends that this statement – a scant two lines in a 90-page decision – was an error of law because it shows that the Tax Court conducted an inquiry into motivation, which is forbidden, and that the court failed to look at the origin of the claims as required by *United States v. Gilmore,* 372 U.S. 39 (1963).

In *Gilmore,* the undisputed leading case on this issue, the Court said that, in making a determination as to whether an expenditure is for business purposes or for personal purposes, one must look to the origin and nature of the claim, not the potential consequences of the litigation to the taxpayer. Gilmore, the taxpayer, tried to deduct as an ordinary and necessary business expense the litigation costs of his divorce because in the divorce action his wife was claiming a community share of his assets, primarily controlling interest in three GM dealerships. Gilmore wanted to defeat the claims because his loss of control of the corporations might cost him his

corporate positions and thus his livelihood. He also claimed that his wife's "sensational and reputation-damaging charges of marital infidelity" might cause GM to cancel the franchises. Even though Gilmore argued that through the litigation he was trying to preserve his corporations, the Court determined that the claim did not arise in connection with his profit-making activities.

We are convinced that in the case before us the Tax Court was looking – as is proper – to the origin of the claim and whether it grew out of the profit-making activity of NITCO. We agree that the origin of the claim did not involve NITCO's profit-making activities; in fact, it had nothing to do with NITCO's profit-making activity. Rather, it had to do with Mussman's assistance, through NITCO, to Rhys's business venture. NITCO, itself, could not enter the cable market. Its involvement with NICATV, far from being profit-driven, was a subsidy to Rhys' company. NITCO paid Rhys' salary, which it justified by saying that Rhys was providing consulting services. Some NITCO employees constructed and operated NICATV. NICATV leased office space from Robert Mussman for $150 per month while NITCO paid NICATV's utility bills to the tune of $6,000 in 1988 and $3,000 in 1989, for which there is no evidence of reimbursement. NITCO wrote off as uncollectible a debt of $122,000 owed it by NICATV in spite of the fact that Rhys sold the company for $4 million. A contract regarding the use of NITCO poles for cable and office space came into existence only after Comark brought its FCC complaint. The fact that after the FCC got wind of what was going on NITCO was required to defend itself against a possible fine is really a consequence of its gratuitous action; it does not transform

NITCO's involvement with NICATV into a profit-making activity. The claim in this case originated with the non-business activity of underwriting Rhys. In short, the Tax Court got it right; these are not ordinary and necessary business expenses. It follows then that they are, as the Tax Court found, constructive dividends to Robert Mussman.

We now move to the other issue, whether NITCO allowed its earnings to accumulate beyond the reasonable needs of its business. If it did, then it becomes liable for the accumulated earnings tax.

Whether NITCO was avoiding the payment of income taxes by accumulating earnings and profits beyond the reasonable needs of its business is a question of fact reviewed for clear error. *Engineering Corp. of America v. United States*, 284 F.2d 302 (7th Cir. 1960).

The tax, imposed by § 531 of the code, is to discourage corporate retention of earnings for the purpose of avoiding the individual income tax on distributions of dividends to shareholders. *Ivan Allen Co. v. United States*, 422 U.S. 617 (1975). The purpose is to compel corporations to distribute profits not needed for the conduct of its business. *United States v. Donruss*, 393 U.S. 297 (1969). The fact that a corporation permits earnings to accumulate beyond its reasonable needs is "determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary." § 533. However, tax avoidance need not be the primary or only purpose of accumulation of earnings, but merely one purpose.

We can look to the income tax regulations for guidance in our inquiry. The regulations say that in order for a corporation to justify an accumulation of earnings and profits there must be an indication that the future needs of the business require such accumulation, and the corporation must have specific, definite, and feasible plans for the use of the funds. 26 C.F.R. § 1.537-1(b)(1). Where the future needs of the business are uncertain or vague, where the plans for the future use of an accumulation are not specific, definite, and feasible, or where the execution of a plan is postponed indefinitely, the accumulation cannot be justified as necessary for the reasonable needs of the business. 26 C.F.R. § 1.537-1(b)(1). Circumstances which suggest that the earnings and profits are being accumulated include loans to shareholders, expenditure of corporate funds for the personal benefit of shareholders, loans without a reasonable relation to the business and made to relatives or friends, and retention of earnings and profits to insure against unrealistic hazards. 26 C.F.R. § 1.537-2(c).

As with the first issue on this appeal, the analysis of this issue is highly fact-specific. It is necessary to look at the facts regarding improvements made to the company and its anticipated future needs for revenue to determine whether NITCO's accumulated earning were reasonable. In its petition commencing its case in the district court NITCO did not allege any specific business needs for which it was accumulating its earnings. NITCO had no contemporaneous records indicating plans for the use of the accumulated earnings. However, during pretrial discovery on March 4, 1992, it claimed that it needed the accumulated earnings because it planned to replace its

switching equipment, to acquire certain signaling technology, to offer services such as call forwarding, to save for increased services in the event that a new airport were built near NITCO's service area, to save for expansion of its principal office facilities, and to purchase a computer for billing purposes.

Testing these claims against NITCO's actions, we see that it is true that during the 1980's NITCO underwent some changes. It moved its Hebron business headquarters from one building to a larger one that was just down the street. However, both buildings in which the company was housed were owned by Robert Mussman. After the company moved to new quarters, the old offices were used by NITCO for storage or leased to Rhys' cable television company.

In 1986 NITCO's responsibility for billing of customers was reduced by AT&T's assumption of the task of billing for long-distance service. In 1989 NITCO contracted out the local billing to the Bank of Illinois and was still utilizing the bank's services in 1991. It was not until 1992 that NITCO spent about $780,000 for a new computer to allow it to handle its own billing.

During 1985 to 1988 NITCO replaced its old switching equipment with new digital equipment manufactured by a French company called Alcatel. When the change was made in the switching equipment, NITCO paid off the remaining debt of $669,530 owing on its old equipment. The new equipment gave NITCO the ability to provide modern telephone services like three-way calling

and call forwarding. NITCO represented in its publications circulated to its customers that the Alcatel equipment was state of the art. Between 1987 and 1992 there is no indication that NITCO obtained bids to replace the Alcatel equipment. In 1992 NITCO obtained a bid for the price of replacement equipment but at the time of trial had not purchased any equipment to replace its still relatively new, state-of-the-art Alcatel switching equipment.

NITCO also replaced some of its copper cable with fiber-optic cable in some parts of its telephone service system, but between 1987 and the time of the trial it had not installed fiber-optic cable in residences or in the business premises of its customers. In fact, in a paper he prepared for the telephone industry in 1989, Kyle Mussman said that there was no economic justification for local telephone companies to install fiber-optic cable in residences. In addition, although during the 1980's NITCO applied for licenses for cellular phone service, the company transferred to other entities owned by the Mussman family any rights it obtained.

The Tax Court found that no dramatic expansion of NITCO's customer base could be reasonably expected. The judge discounted the possibility of a new Chicago area airport being located in or near its service area, saying it was speculative because only 4 of the 15 possible sites for the airport were near NITCO. In short, the Tax Court found that some of NITCO's alleged justifications for the accumulated earnings were thought of after the fact – that is, after the deficiency assessment.

Also, NITCO's actual use of the funds does not show that it planned to expand. In fact, a large part of its accumulated earnings was used to fund other ventures of the Mussman family. NITCO pledged $3.6 million to Kyle's Blue Mountain Cellular Telephone. NITCO paid money to both sons even after they were no longer employed by the company. Corporate funds were used to pay Rhys' country club membership when he was no longer an employee. These findings support the conclusion that NITCO allowed earnings to accumulate beyond its reasonable needs and that it did not show by a preponderance of the evidence that it did not have a tax avoidance purpose.

But in what seems to be an attempt to avoid review under the clear error standard and to have us look at the cases *de novo*, NITCO also contends that the Tax Court committed an error of law when it failed to apply a "flexible standard of law" in regard to closely held corporations. The argument is that such corporations cannot be held to the same strict formalities as large public corporations. So, NITCO contends, the fact that it had virtually nothing in writing about its plans and that some of the plans seemingly were concocted after the audit began is of very little relevance.

The argument is an exercise in revisionist history. The accumulated earnings tax was originally assessed primarily against closely held corporations. B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 7.02 (6th ed.1996). The tax was to prevent the formation of corporations to shelter individual shareholders, a much more likely event in a closely held corporation. In fact, in 1974, even though the statute then in

effect did not distinguish between publicly held and closely held corporations, the Ninth Circuit declined to impose the tax on a publicly held corporation. *Golconda Mining Corp. v. Commissioner*, 507 F.2d 594. That result was corrected in 1984 when Congress enacted § 532(c), which provided that liability must be determined without regard to the number of shareholders. This little bit of history seems to us to send a clear message that publicly held and closely held corporations are not to be treated differently under this statute. But if they were to be treated differently, it seems unlikely that closely held corporations, with their greater incentive to shelter their shareholders, are the ones which would be treated more leniently. This remains true even now, when the tax rates for individuals and for corporations have been more closely aligned. The fact that after-tax corporate income is taxed a second time when it is distributed to shareholders provides a continuing incentive for the corporation to retain earnings. *See* Bittker & Eustice, ¶ 7.01. We are not convinced that the Tax Court committed an error of law on this point.

The decision of the Tax Court is AFFIRMED.

A true Copy:

Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit

T.C. Memo. 1996-168

UNITED STATES TAX COURT

NORTHWESTERN INDIANA TELEPHONE COMPANY, Petitioner *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

ROBERT G. MUSSMAN AND MYRTIS MUSSMAN, Petitioners *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent[1]

Docket Nos. 7970-91, 7971-91. Filed April 2, 1996.

R determined that NITCO, a local telephone company, unreasonably accumulated its earnings and profits and, therefore, was subject to accumulated earnings tax. R further disallowed business deductions NITCO claimed for legal expenses and determined that NITCO was liable for certain additions to tax.

R determined that M, NITCO's president and major shareholder, had constructive dividend income and that M and M's wife were liable for certain additions to tax.

1. *Held*: NITCO is liable for accumulated earnings tax because its accumulated earnings exceeded its reasonable business needs and NITCO was availed of to avoid income tax with respect to its shareholders.

2. *Held, further,* most of the legal expenses in issue are not deductible under sec. 162, I.R.C.

3. *Held, further,* M had constructive dividend income.

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[1] This Court granted petitioners' motion to consolidate.

4. *Held, further,* NITCO is liable for the additions to tax.

5. *Held, further,* M and M's wife are liable for the additions to tax.

David J. Duez, Gail H. Morse, and *Roger W. Wenthe,* for petitioners.

Marjory A. Gilbert, Linda Grobe, and *Claire McKenzie,* for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

RUWE, *Judge*: Respondent determined deficiencies in petitioners' Federal income taxes and additions to tax as follows:

Northwestern Indiana Telephone Co.
docket No. 7970-91

		Additions to Tax				
Year	Deficiency	Sec. 6653(a)(1)(A)	Sec. 6653(a)(1)(B)	Sec. 6661	Sec. 6662	Sec. 6621(c)
1987	$786,115.00	$39,305.75	[1]	$182,675.75	–	[2]
1988	429,006.00	21,450.30	–	101,935.50	–	[2]
1989	329,369.00	–	–	–	$23,509.40	–

Robert G. and Myrtis Mussman
docket No. 7971-91

		Additions to Tax		
Year	Deficiency	Sec. 6653(a)(1)	Sec. 6661	Sec. 6662
1988	$74,850.00	$3,742.50	$18,712.50	–
1989	127,004.00	–	–	$25,400.80

[1] 50 percent of the interest due on $55,412.

[2] 5 percent of the interest due on the deficiency.

After concessions, the issues we must decide are: (1) Whether petitioner Northwestern Indiana Telephone Co. (NITCO) permitted its earnings to accumulate beyond the reasonable needs of the business during the years 1987, 1988, and 1989; (2) whether NITCO was availed of for the proscribed purpose of avoiding income tax with respect to its shareholders and is liable for the accumulated earnings tax under section 531,[2] for 1987, 1988, and 1989; (3) whether NITCO, for 1987, 1988, and 1989, is entitled to business deductions for certain legal expenses it incurred and/or paid; (4) whether petitioner Robert G. Mussman received constructive dividend income in the years 1988 and 1989; and (5) whether Petitioners are liable for additions to tax.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts, first and second supplemental stipulations of fact, and attached exhibits are incorporated herein by this reference.

At the time their petitions were filed, NITCO maintained its principal office in Hebron, Indiana, and petitioners Robert G. and Myrtis Mussman resided in Hebron, Indiana. Mr. and Mrs. Mussman filed joint individual income tax returns for 1988 and 1989.

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[2] Unless otherwise indicated, all section references are to the Internal Revenue Code as in effect for the years in issue, and all Rule references are to the tax Court Rules of Practice and Procedure.

A. Background on NITCO and the Mussman Family

NITCO, an Indiana corporation, is an independent telephone company that provides local wire-based telephone services in the five following rural areas located in northwestern Indiana: (1) Roselawn, (2) Mt. Ayr, (3) Demotte, (4) Lakes of the Four Seasons, and (5) Hebron. It operates a local telephone company office or exchange in each of these areas. In each of the years 1987, 1988, and 1989, NITCO had a total of 7,238, 8,099, and 8,634 access lines, respectively. Most of these access lines were for residential customers. NITCO had relatively few multiline business customers. As of 1989, NITCO had 16 multiline business customers, none of whom had lines in excess of 10.

Since 1982, petitioner Robert G. Mussman (Mr. Mussman) has been NITCO's president and chief executive officer. He has owned approximately 95 percent of NITCO's outstanding shares of stock since at least 1982. The balance of NITCO's outstanding shares has been owned by Mr. Mussman's brother, Gerald Mussman. Since 1982, Gerald Mussman served as NITCO's vice president, and petitioner Myrtis Mussman (Mrs. Mussman) served as its secretary-treasurer. During the years in issue, Mr. and Mrs. Mussman and Gerald Mussman were NITCO's only directors and officers.

During 1987 through 1989 and in prior and subsequent years relevant to these instant cases, Mr. Mussman was the primary decision maker at NITCO. He made all final major decisions concerning NITCO's operation and how its earnings were spent.

Mr. and Mrs. Mussman have two sons, Rhys Mussman (Rhys) and Kyle Mussman (Kyle). Rhys was born in 1956 or 1957; Kyle was born in 1965 or 1966. Each son, at various times pertinent to the instant cases, worked as a full-time employee of NITCO. They also, at various times pertinent to the instant cases, left NITCO's employ to pursue other business ventures for their own accounts, including a cable television company business and various cellular telephone company businesses.

NITCO's local telephone business has been a family-owned and-operated business. The business was originally owned and operated by Mr. Mussman's father. Mr. Mussman began working in the business as a teenager in 1938. From about 1947 through the time of the trial in the instant cases, Mr. Mussman worked as a full-time employee in the business. Gerald Mussman left the family business in 1947 when he took a job with AT&T.

When Mr. Mussman's father died in 1954, Mr. Mussman inherited his father's NITCO shares. At various times since 1954, NITCO offered additional shares of its stock to Mr. Mussman and his brother, Gerald Mussman. Mr. Mussman purchased the shares offered to him, but his brother declined to purchase additional shares.

Throughout the 1950's, NITCO's earnings were fairly moderate. In 1951, NITCO's annual net income was about $9,800. By 1987, however, NITCO's annual revenue exceeded $5 million.

In the early 1960's, Interstate Highway 65 was constructed through NITCO's service area. The completion of the highway spurred development and economic growth in NITCO's service area, which resulted in increased

annual revenue for NITCO. New subdivisions of homes were built, and portions of NITCO's service area eventually included bedroom communities composed of individuals who worked in the Gary, Indiana, area, and in the Chicago, Illinois, area.

NITCO's annual revenue and profits began to increase significantly in late 1985, as a result of the breakup of the Bell system and the entry of other companies into the long-distance telephone service market in competition with AT&T. Generally, when a long-distance telephone service company, like AT&T, originates or places a long-distance call into or from an area serviced by a local telephone company, it pays the local telephone company an access charge for the use of its lines. Prior to the breakup of the Bell system, AT&T alone established and prescribed the access charges it paid to local telephone companies. Following the breakup of the Bell system, an independent entity, the National Exchange Carriers Association, was established and given responsibility over deciding how long-distance call revenues were divided among all telephone service providers.

B. NITCO's Principal Business Office and Headquarters

From about 1980 through the time of the trial, NITCO maintained its principal business office and headquarters in an office building at 205 North Washington Street. Hebron, Indiana. NITCO leased the office building from Mr. Mussman, who owned the building and the parcel of land on which the building is situated.

Mr. Mussman also owned another smaller office building situated on the same parcel of land, with the address 301 North Washington Street, Hebron, Indiana. Prior to its moving into and occupying the newer and larger building at 205 North Washington Street, NITCO maintained its principal business office at the 301 North Washington Street building, which it leased from Mr. Mussman. From 1980 through 1993, NITCO continued to lease the 301 North Washington Street building from Mr. Mussman. From 1983 until about July 1989, NITCO subleased the 301 North Washington Street office building to Rhys' cable television company. After Rhys' cable television company vacated the premises in July 1989, NITCO used the 301 North Washington Street building for storage and later, in the fall of 1993, moved some of its marketing division employees into the building.

From 1987 through 1989, NITCO had no plans to build other principal office facilities for itself or to expand and enlarge its offices at 205 North Washington Street. In securing office facilities for NITCO, Mr. Mussman's longstanding practice was to own individually the office building and lease it to NITCO. As the building's owner, Mr. Mussman, rather than NITCO, financed and constructed the building. NITCO's respective lease agreements with Mr. Mussman on the 205 and 301 North Washington Street buildings were entered into prior to each building's construction, so that Mr. Mussman could use the executed lease agreement to secure financing from a lender to construct the building. Mr. Mussman experienced no difficulty in obtaining loans to construct the 205 and 301 North Washington Street buildings. The lease agreements and the mortgages on the buildings

served as the security for the lender's loans to Mr. Mussman.

No enlargement of NITCO's offices at 205 North Washington Street occurred from 1987 through 1994.

C. NITCO's Alcatel Telephone Switching Equipment

During 1985 through 1987, NITCO replaced the old switching systems at its five exchanges with new digital switching equipment it purchased from Alcatel, a French manufacturer of telephone switching equipment. After it replaced the old switching equipment at its exchanges with the new Alcatel switching equipment, NITCO paid off the remaining purchase money debt of $669,530 that it owed on the old equipment to the old equipment's manufacturer.

When NITCO ordered the Alcatel E10-5 switching equipment for its file exchanges in 1985, Alcatel had represented to NITCO that Alcatel would continue to engage in research and development efforts that would allow the Alcatel equipment that was purchased to be upgraded in future years so as to offer enhanced and improved telephone services. In 1988, NITCO purchased and installed another piece of Alcatel switching equipment, an Alcatel 1210 access tandem toll switch, at its central office. The Alcatel E10-5 switching equipment installed in NITCO's five exchanges performs switching functions in each exchange and is connected to the Alcatel 1210 tandem toll switch, which provides access to long-distance telephone service carriers, equal access, and 800 call capability to all of NITCO's exchanges. With

the E10-5 switches and the 1210 switch, NITCO can provide equal access, touch-tone services, direct long-distance dialing, call forwarding, call waiting, three-way calling, speed dialing, foreign exchange lines, pbx services, call tracing, and 911 services to all its exchanges.

In various 1990 NITCO publications circulated to NITCO's customers and employees. NITCO stated that the Alcatel switching equipment it had installed within the past 5 years was state of the art equipment that offered the latest calling features. NITCO's operating experience with its Alcatel equipment has been good.

In an August 17, 1990, response that was submitted by NITCO to a service audit report issued by the engineering staff of the Indiana Utility Regulatory Commission (IURC), NITCO indicated that Alcatel was continuing future research and development efforts with respect to NITCO's Alcatel equipment. To support this representation, NITCO attached to its response a copy of a letter dated August 14, 1990, from Mr. James V. Parish, national sales account manager – ITT-Alcatel – stating that Alcatel was not withdrawing from the North American switching market, had no plans to do so, and was providing a complete line of support for its switching systems equipment.

From 1987 through sometime in 1992, NITCO did not obtain any bids on new switching equipment to replace its Alcatel switching equipment. In 1992, NITCO for the first time obtained a firm quotation on the price of possible replacement equipment. As of the time of trial, however, NITCO has not purchased new switching equipment to replace its Alcatel switching equipment.

D. NITCO's Installation of Fiber Optic Cable

Although it is more costly than the traditional copper cable still extensively used by local telephone companies, fiber optic cable has certain definite advantages over copper cable. The fiber optic cable is much smaller in size and has a greater transmission capacity than copper cable. It further allows higher speed transmissions and requires less maintenance than copper cable.

However, from 1987 through the time of trial, it was not economically feasible for NITCO to install fiber optic cable in the homes or business premises of its customers. From 1986 until sometime in 1987 or 1988, Kyle was NITCO's fiber optic cable specialist. During 1989, while he was employed as NITCO's general manager, Kyle authored and published a white paper for the independent telephone industry stating that, at that time and for the immediate future, installation of fiber optic cable by local telephone companies in residences was not economically feasible. In the paper, Kyle expressed the opinion that there was then no economic justification for local telephone companies to incur the high cost of installing the fiber optic cable in residences, because no significant additional revenues would yet be produced for them from their installation of the cable in residences.

From 1987 through the time of trial, NITCO has not installed fiber optic cable in residences or in the business premises of its customers. However, NITCO has installed and utilized fiber optic cable in connection with other parts of its telephone service system. Its employees have laid and installed the fiber optic cable. During 1987 through 1989, NITCO was installing fiber optic cable to

connect its five exchanges. Most of this work to connect its exchanges was completed in 1987 and 1988. In 1989, NITCO installed fiber optic cable to a point in its service area where it located a switching device to handle calls to homes using traditional copper cables. Since 1990, NITCO has installed fiber optic cables in a few new subdivision areas to service homes in the subdivisions that had copper cables. In addition to the fiber optic cable's better performance and reliability and its potential future capacity for offering other new or enhanced services that might become available, the fiber optic cable was cheaper to install in these subdivision areas because of its smaller size.

E. NITCO's Billing and Collections Work

Prior to 1986, in addition to billing and collecting payments for its own local telephone services, NITCO billed and collected payments for long-distance calls from customers in its service area who utilized AT&T's long-distance telephone services. With respect to the long-distance payments it collected on behalf of AT&T, NITCO subtracted the access charges due to it, as well as an administrative and collection fee, and then was required to remit the balance of the long-distance payments to AT&T.

NITCO owned an IBM computer, which it used to help perform its billing and collections work. In late 1986, AT&T took back the long-distance billing and collections function that NITCO previously performed for AT&T with respect to long-distance calls.

In October 1989, NITCO and Bank of Illinois entered into a 3-year contract under which Bank of Illinois agreed to perform NITCO's billing and collections work. In a November 1989 NITCO publication circulated to its employees, NITCO announced that the new NITCO billing system to be operated by Bank of Illinois would help to (1) improve service to NITCO's customers, and (2) increase the productivity of NITCO's employees. Another reason why NITCO entered into the contract was because the IBM computer that NITCO owned could not provide all the information on long-distance calls that NITCO was required to furnish to AT&T. The contract was subsequently taken over from Bank of Illinois by another company, Communications Data Group (CDG).

As of September 1991, although it had experienced some problems with the billing and collections work done, NITCO was still utilizing CDG's billing and collections services. At a meeting on October 25, 1991, attended by NITCO personnel and CDG personnel at the offices of NITCO's attorneys, NITCO and CDG agreed that NITCO would continue to utilize CDG's billing and collections services. However, the problems with the billing and collections work done for NITCO persisted.

In 1992, NITCO purchased and paid approximately $781,000 for a new computer to perform its own billing and collections work. NITCO also hired additional employees to operate the net computer and to perform this work. Thereafter, employees of NITCO utilized this computer to perform NITCO's billing and collections work.

During 1987 through 1989, NITCO had no specific and definite plans to buy a computer to perform its billing and collections work.

F. Long Range Planning and Discussions Concerning a Proposed Airport in or Near NITCO's Service Area

At various times during 1987 through 1989, long-range planning and discussions were taking place concerning a proposed new airport in Indiana to service the Chicago, Illinois, area. Proponents of the airport project anticipated that the proposed airport eventually would be needed, because Chicago's O'Hare airport was already being heavily used. The proponents believed that, as O'Hare airport's maximum air traffic capacity was reached (which some of them predicted could occur as early as 2010 through 2020). Much of the increased air traffic to the Chicago area would have to be accommodated at a new Indiana airport.

During the years in issue, 4 of the 15 possible sires in Indiana discussed for the proposed airport were either in or near NITCO's service area. However, a final decision concerning the building of the airport and the selection of its site was not likely to be made for a number of years. As of the time of trial, no decision had yet been made concerning the building or site of the proposed airport, and there were no current plans to build the airport in or near NITCO's service area.

G. Cellular Telephone and Long-Distance Telephone Service License Applications Filed by Mr. Mussman, NITCO, and Another Company Mr. Mussman Controlled

In order to offer cellular telephone or long-distance telephone services in a specific area, the potential service provider must first apply for and obtain authorization from either the Federal Communications Commission (FCC) or an appropriate State regulatory agency.

During the 1980's, the FCC held lotteries to select the applicants to whom it would issue licenses to build and operate cellular telephone systems serving various areas of the United States. The FCC issued two types of cellular telephone licenses: (1) On frequency B, only to local wireline telephone companies, their owners, and affiliates who were under the common control of local telephone companies and/or their owners; and (2) on frequency A, to anyone else other than local telephone companies, owners of local telephone companies, and their affiliates. If a cellular telephone licensee failed to provide the required level of cellular telephone service to the entire area covered under the license issued to it within a 5-year period, then the FCC could take back the license to the unserviced portion of the licensee's service area and issue a new license to another qualified applicant to provide cellular telephone service to the unserviced portion of the area.

In 1988, Lukas, McGowan, Nace & Gutierrez (LMN&G), a Washington, D.C., law firm that specializes in communications law, prepared and filed with the FCC at least 78 cellular telephone license applications on

behalf of either Mr. Mussman, Kyle, or Rhys. Previously, in 1986, Rhys applied for and was tentatively selected to be awarded two licenses to furnish cellular telephone services in Enid, Oklahoma, and in Asheville, North Carolina, respectively. Rhys' Enid, Oklahoma, and Asheville, North Carolina, cellular telephone business activities were conducted by him through Dial One Mobile, a company Rhys solely owned. Almost all the 78 applications LMN&G filed in 1988 were for Kyle and Rhys. During 1988, NITCO paid the filing fees with respect to the 78 license applications and deducted the payments. Petitioners have conceded that NITCO should not have deducted these payments of Mr. Mussman's, Kyle's, and Rhys' license application filing fees.

LMN&G also performed a substantial amount of other legal work for NITCO and the Mussman family during the years in issue.

Mr. Mussman's Hagerstown, Maryland, and Cumberland, Maryland-West Virginia Cellular Telephone License Applications

On or about January 6, 1988, Mr. Mussman filed with the FCC two cellular telephone license applications to provide cellular telephone services in the Hagerstown, Maryland, and the Cumberland, Maryland-West Virginia, areas, respectively. An LMN&G attorney prepared the two applications.

NITCO had no interest in the above license applications. The applications stated that Mr. Mussman was the applicant and that NITCO had no interest in the licenses being sought.

NITCO's Indiana Rural Statistical Area Number One Cellular Telephone License Application and Serv-U-Cellular, Inc.

In 1988, NITCO, certain other local wire-line telephone companies, and/or affiliates of other local wire-line telephone companies, filed competing applications with the FCC for a license to provide cellular telephone service in the rural statistical number one area in Indiana. Mr. Mussman's intention and plan was to transfer the cellular telephone license rights that NITCO obtained to Serv-U-Cellular, Inc. (Serv-U-Cellular), a corporation that he and one or more of his sons, individually, would own. At that time, when competing cellular telephone license applications were filed by local wire-line telephone companies and/or their affiliates, it was a common occurrence for some license applicants to join subsequently in a partnership to build and operate the cellular telephone system that serviced the area.

As a result of an agreement among various applicants who sought the rural statistical number one area cellular telephone license, they agreed to withdraw their license applications to service the area as follows: (1) All the applicants except a company called Ameritech would withdraw their applications to service the area's northern portion; and (2) all the applicants would either withdraw or amend their applications so that NITCO and certain of the other applicants could form and participate in a partnership to service the area's southern portion. Subsequently, RSA #1, a limited partnership, was formed for this purpose. Ameritech further agreed to pay the other applicants $750,000 each for their agreement to cede the

northern portion of the rural statistical number one area to Ameritech.

On or about September 24, 1990, an LMN&G attorney sent letters advising the other participants in RSA #1 that Serv-U-Cellular, rather than NITCO, would be a limited partner in the RSA #1 limited partnership. The attorney's letter to them stated that Serv-U-Cellular was a newly formed "subchapter S corporation" whose shares of stock were owned by individual members of the Mussman family and that Mr. Mussman would own and vote 51 percent of Serv-U-Cellular's shares.

By October 9, 1990, the RSA #1 partnership agreement was amended to reflect Serv-U-Cellular's substitution in place of NITCO as a limited partner in the RSA #1 limited partnership. Under the original RSA #1 partnership agreement entered in mid-1989, NITCO and the other partners had agreed that subsidiaries or affiliates of a partner would be allowed to assume the partner's rights and obligations in and to the partnership.

In 1990, Serv-U-Cellular received $750,000 as a result of the agreement to cede the northern portion of the rural statistical number one area to Ameritech. NITCO received the $750,000 from Ameritech and paid it to Serv-U-Cellular.

Pursuant to Mr. Mussman's plan, Serv-U-Cellular was to be owned individually by him and Rhys. Mr. Mussman was to own 6 percent and Rhys was to own 94 percent of Serv-U-Cellular's outstanding shares of stock.

Mr. Mussman subsequently decided to abandon his plan that he and Rhys individually own Serv-U-Cellular,

as a result of the Internal Revenue Service's (IRS) commencement of the examinations that led to the instant proceedings. On its 1990 return dated September 12, 1991, NITCO reported in its income $696,772 of the $750,000 payment that Serv-U-Cellular had received from Ameritech. Attached to its Form 1120 for the tax year 1991, Serv-U-Cellular notified the IRS of the termination of Serv-U-Cellular's S corporation status as a result of the transfer of all its shares to NITCO on January 1, 1991. However, on its annual reports for 1990, 1991, and 1992, to the FCC and the Indiana Utility Regulatory Commissioner (IURC), NITCO did not report that it had any subsidiaries.

Dial One USA, Inc.

Dial One USA, Inc. (Dial One USA), was a wholly owned subsidiary of Intelcom, Inc. (Intelcom). Mr. Mussman was the principal stockholder of Intelcom.

In 1989, Dial One USA petitioned the IURC for a certificate of territorial authority for authorization to be a reseller of long-distance telephone services. In connection with the petition, Mr. Mussman essentially acknowledged that he owned Dial One USA through Intelcom but stated that there was no affiliation between NITCO and Dial One USA. At that time, the IURC had certain concerns with respect to a local telephone company's having a long-distance telephone service affiliate.

After reviewing Dial One USA's application, the IURC staff requested further information concerning the allocation of Dial One USA's expenses between it and NITCO. In September 1989, Dial One USA moved to

dismiss its application and did not provide the information the IURC staff requested. NITCO had paid certain legal and other expenses of Dial One USA and had paid certain legal expenses attendant to the incorporation of Dial One USA's parent, Intelcom.

H. Possible Acquisition of Other Local Telephone Companies by NITCO or the Mussman Family

During the years in issue, Mr. Mussman, on several occasions, had asked certain individuals with whom he was acquainted, including an accountant, an attorney, and a communications consultant to apprise Mr. Mussman of potential opportunities to acquire other local telephone companies. On the record presented in the instant cases, it is not clear whether Mr. Mussman intended and planned to have NITCO or individual members of the Mussman family ultimately acquire other telephone companies.

In 1990, NITCO contacted two local telephone companies about the possibility of acquiring them. One telephone company replied that it was not for sale; the other company never responded to NITCO's inquiry.

Additionally, in 1990, Rhys visited another local telephone company located in Tennessee to examine its operations and to discuss its possible purchase. Rhys' trip took place after the IRS' commencement of the examinations that resulted in the instant cases.

From 1987 through the time of trial, NITCO did not enter into a contract to purchase another local telephone company.

I. NITCO's provision of Financial Assistance to Mr. Mussman's Sons and Various Companies the Sons Owned

Rhys and Northwestern Indiana CATV, Inc.

Prior to 1983, Northwestern Indiana CATV, Inc. (NICATV), a corporation that Rhys owned, applied for and was issued a license by the FCC to offer cable television services in certain areas in Indiana. NITCO provided local telephone services in these same areas. To help Rhys and NICATV obtain the financing needed to build NICATV's cable television system, Mr. Mussman personally guaranteed the bank loan to NICATV.

From 1983 through 1988, NITCO's employees helped construct NICATV's cable television system. From 1983 through about July 1989, NICATV maintained its offices at the 301 North Washington Street building that it subleased from NITCO. It further leased or subleased from NITCO a small area of cleared land located behind NITCO's office building at 205 North Washington Street and telephone pole space for cable television attachments. In 1988 and 1989, NITCO paid a total of at least $6,119.95 and $3,263.51, respectively, in utility bills at the 301 North Washington Street building.

NITCO had no ownership interest in NICATV or in NICATV's cable television facilities.

In 1983, Rhys, NICATV, and NITCO became involved in a dispute before the FCC concerning whether NICATV was an affiliate of NITCO. The FCC later took the position that NICATV was a NITCO affiliate, in large part because of the extensive financial support and other

assistance NICATV and Rhys received from Mr. Mussman and NITCO. This dispute continued for a number of years and was not resolved until after Rhys sold NICATV to an unrelated party in July 1989. The FCC proceedings and other related legal proceedings that arose from this dispute are discussed more fully *infra*.

The cable television system construction work and other various activities NITCO engaged in, from 1983 to 1989, with respect to NICATV were not undertaken by NITCO with a profit motive. As of about 1989, NITCO's books reflected that Rhys and NICATV owed NITCO in excess of $122,000. In July 1989, Rhys sold NICATV for about $4 million. Although Rhys received sufficient cash from his sale of NICATV to discharge this $122,000 "debt" to NITCO, the "debt" owed to NITCO remained unpaid. On the 1989 annual report it filed with the IURC in May 1990, NITCO indicated that it had written off as uncollectible its $122,000 "receivable" with respect to Rhys and NICATV and stated that this was a "Non-deductible write-off" for tax purposes.

NITCO's 1988 Payment to Rhys and its 1989 Purchase of a Country Club Membership for Rhys

Rhys left NITCO's employ and was no longer an employee of NITCO after December 31, 1983. However, during 1984, NITCO continued to pay Rhys a "salary", provided him with health insurance coverage, and allowed him to participate in NITCO's retirement plan. As a result of the FCC's taking issue with these payments and benefits that NITCO provided to Rhys, on or about May 31, 1985, an attorney representing NITCO advised

the FCC that Rhys would no longer serve as a "consultant" to NITCO and indicated that NITCO's provision of such money and benefits to Rhys would cease. As indicated above, the dispute between NICATV, NITCO, and the FCC continued for some time and was not resolved until after Rhys' July 1989 sale of NICATV. Additionally, in the March 24, 1988, complaint NITCO and Rhys filed in the constitutional challenge action discussed *infra*, NITCO alleged that Rhys did not receive compensation from NITCO and had no formal responsibilities at NITCO.

On December 20, 1988, NITCO paid $22,646 to Rhys. In early 1989, NITCO purchased individual memberships at a local country club on behalf of several of its employees and on behalf of Rhys. NITCO paid an $1,800 initiation fee to obtain Rhys' club membership. At this point, Rhys had not yet sold NICATV and was not an employee of NITCO.

Blue Mountain Cellular Telephone, Inc., FiberComm, Inc., and BMCT, L.P.

In 1988, FiberComm, Inc. (FiberComm), a corporation solely owned by Kyle, applied to the FCC for a license to provide cellular telephone services in the rural statistical number three area in Oregon. On October 20, 1989, the FCC issued FiberComm a cellular telephone license to the area. FiberComm previously had obtained a financing commitment from an unrelated party to help it construct its Oregon cellular telephone system. Although FiberComm's cellular telephone system began operating in January 1991, and as of March 31, 1991, FiberComm had

105 subscribers to the system's cellular telephone services, further construction work with respect to the system was needed. In April 1991, FiberComm assigned its Oregon rural statistical area number three cellular telephone license to Blue Mountain Cellular Telephone, Inc. (BMCT), another corporation solely owned by Kyle.

BMCT was formed in October 1990. In late 1990, BMCT entered into an agreement to purchase for $3,615,771 a cellular telephone license and other assets from WKBN Broadcasting Corp. (WKBN). BMCT and WKBN were unrelated parties. During its negotiations with BMCT, WKBN was advised and represented by a large nationally known law firm.

The above purchase of the cellular telephone license and other assets would allow BMCT to operate a cellular telephone system in the rural statistical number eight area of Washington State. Although WKBN's cellular telephone system for the area began operating in January 1991, and as of March 31, 1991, there were 85 subscribers to the system's cellular telephone services, further extensive construction work with respect to the system was needed.

To help effectuate its purchase of the Washington rural statistical area number eight cellular telephone license and other assets, in late 1990, BMCT applied to a local Indiana bank for a letter of credit for approximately $2.99 million. The bank issued the letter of credit after Mr. Mussman executed an agreement pledging certain of NITCO's assets, including certain certificates of deposit and interests in various governmental securities, to cover the bank's potential liability under the letter of credit. In

addition, in 1990, NITCO loaned BMCT $500,000 to use as a downpayment on BMCT's purchase of the cellular telephone license and other assets.

On or about April 22, 1991, NITCO loaned BMCT another $3.1 million, so that the principal amount of NITCO's outstanding loans to BMCT totaled in excess of $3.6 million. With this additional $3.1 million loan from NITCO, BMCT was then able to conclude its purchase of the cable telephone license and other assets from WKBN on April 22, 1991.[3] As a result, the above letter of credit issued by the local Indiana bank was canceled.

At about the time of its April 22, 1991, acquisition of the Washington rural statistical area number eight cellular telephone business, BMCT arranged to borrow another $2.8 million from an unrelated third party, to finance further construction of the Washington Cellular telephone system. To help BMCT obtain the $2.8 million loan from this third party, NITCO agreed to subordinate its prior loans to BMCT to the third party's loan. Thus, the third party generally would enjoy priority over

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[3] An explanatory note to the Dec. 31, 1991, financial statements of BMCT, L.P., the limited partnership that BMCT, FiberComm, and NITCO subsequently formed, reflects that the $3,615,771 purchase price paid by BMCT was allocated to the license and other assets that were acquired as follows:

Land and buildings	$151,143
Cellular license	2,217,265
Equipment	147,363
Warranties	500,000
Consulting agreement	100,000
Noncompete agreement	500.000
Total	$3,615,771

NITCO with respect to having the third party's $2.8 million loan repaid by BMCT.

Kyle ceased being an employee of NITCO around the middle of 1990. He then moved to the Pacific Northwest and resided there in 1991 and 1992 in order to conduct BMCT's and FiberComm's respective operations. In 1991 and 1992, NITCO paid Kyle an annual "salary" of $73,292 and $77,283, respectively. Additionally, from the middle of 1990 through February 1993, Kyle continued to be covered under NITCO's retirement plan and continued to receive coverage under NITCO's dental and health insurance plans.

During 1991 and 1992, BMCT made no interest and principal payments on the loans it received from NITCO.

During the latter part of 1991, Mr. Mussman proposed to Kyle that BMCT, FiberComm, and NITCO form a limited partnership that would undertake to build and operate the Oregon rural statistical area number three and Washington rural statistical area number eight cellular telephone systems. Mr. Mussman told Kyle that he just wanted NITCO to have a short-term investment that paid a guaranteed annual return.

In late 1991, Kyle sold to Rhys: (1) A 46-percent stock interest in BMCT for $61,000, and (2) a 46-percent stock interest in FiberComm for $61,000. By the end of 1991, BMCT owed a total of approximately $3.8 million in principal and interest on the loan it received from the unrelated third party, in addition to the $3.6 million it owed to NITCO.

By about April 1992, BMCT, FiberComm, and NITCO had formed BMCT, L.P. (the BMCT limited partnership). Although the BMCT limited partnership's formation was actually concluded and finalized by them in April 1992, the BMCT limited partnership's written partnership agreement stated that the partnership agreement was made and entered into by them as of November 30, 1991. The partnership agreement provided that BMCT and FiberComm would serve as the general partners and that NITCO would be a limited partner in the BMCT limited partnership. There were no other partners in the BMCT limited partnership.

BMCT and FiberComm contributed all their assets, subject to all their liabilities, to the BMCT limited partnership. NITCO contributed to the BMCT limited partnership the loans it had previously made to BMCT, interest that had accrued with respect to the loans, and certain equipment.

The formation of the partnership was not an arm's-length transaction among BMCT, FiberComm, and NITCO. The respective partnership interests that BMCT, FiberComm, and NITCO received in the BMCT limited partnership were not commensurate with and bore no reasonable relationship to their relative capital contributions to the BMCT limited partnership. Considering the relative amount of NITCO's capital contribution, NITCO'S limited partnership interest was a substantially lesser interest than what NITCO should have obtained had it been dealing at arm's length with the other two partners, BMCT and FiberComm. In addition, to NITCO's detriment, the partnership agreement greatly overvalued

BMCT's and FiberComm's capital contributions to the BMCT limited partnership.

The partnership agreement provided that NITCO would receive annual guaranteed payments from the limited partnership equal to 10 percent of NITCO's capital contribution. The partnership agreement also provided that any remaining cash flow and operating profits would be allocated 99 percent of BMCT and FiberComm, the general partners, and 1 percent to NITCO, the only limited partner. In the event that the BMCT limited partnership was liquidated, the proceeds were to be distributed to the extent of and in proportion to the positive balances in the partners' capital accounts.

Prior to the latter part of 1991, Mr. Mussman and NITCO had not engaged in any discussions with Kyle about the formation of a cellular telephone partnership between BMCT and NITCO. In April 1991, the IRS issued the respective notices of deficiency to petitioners that are the subject of the instant cases. As a result of certain legal advice he and NITCO received from attorneys with the law firm of McDermott, Will & Emery (MW&E), Mr. Mussman decided to have NITCO's loans to BMCT converted to a limited partnership interest in a partnership to be formed among BMCT, FiberComm, and NITCO. A MW&E attorney previously had represented Mr. Mussman and NITCO during the examinations that led to the IRS' issuances of the notices of deficiency in the instant cases. MW&E attorneys also represented NITCO in the formation of the limited partnership.

Pursuant to their partnership agreement, the partners valued their respective capital contributions to the BMCT limited partnership as follows:

General Partner	Description	Value
BMCT	All assets subject to all liabilities	$-0-
FiberComm	All assets subject to all liabilities	6,507,353

Limited Partner	Description	Value
NITCO	Subordinated promissory note dated Apr. 22, 1991, from BMCT, in the principal amount of $3,615,771, together with interest accrued thereon of $210,920 and the contribution of equipment worth $145,862	$3,972,553

On the BMCT limited partnership's December 31, 1991, financial statements, the partners' formation of the partnership was not treated as being an arm's-length transaction among the partners. Certain notes to the BMCT limited partnership's December 31, 1991, financial statements concerning the relative capital contributions made by BMCT, FiberComm, and NITCO, explained, in pertinent part:

> The shareholders of * * * [BMCT] and Fiber-Comm are also related to the majority shareholder of NITCO. Because the partners are all related entities, the assets contributed to the

partnership were recorded at book value for financial reporting purposes.

Contributed assets and liabilities at book value are summarized as follows:

	BMCT	FiberComm	NITCO
Cash	$(834)	$25	$3,615,771
Other current assets	402,145	–	–
Cellular communications assets	2,591,958	4,075	–
Licenses & intangibles	3,099,068	43,331	–
Current liabilities	(510,420)	–	–
Long-term debt	(6,382,521)	(12,093)	210,920
Net capital contributions	(800,604)	35,338	3,826,691

* * *

The limited partner has contributed certain equipment for use by * * * [the BMCT limited partnership], the value of which has not been reflected in the assets or capital accounts. In addition, interest of $210,920 was accrued on the note to the limited partner prior to its conversion to a capital contribution.

On June 9,1994, shortly before the trial in the instant cases, NITCO'S interest in the BMCT limited partnership was redeemed for about $3.6 million.

Although petitioners offered expert witness testimony at trial as to the value of the Oregon rural statistical area number three and Washington rural statistical area number eight cellular telephone businesses, as of March 31, 1991, their experts' appraisal reports grossly inflated

the actual value of these cellular telephone businesses. One appraisal report concluded that FiberComm's Oregon rural statistical area number three cellular telephone business, "free and clear of any encumbrances", was worth $12,039,000, as of March 31, 1991. The other appraisal report concluded that the Washington rural statistical area number eight cellular telephone business, "free and clear of any encumbrances", was worth $8,253,000, as of March 31, 1991.

These inflated valuations were based on revenue projections of the mean annual revenue produced by certain other cellular telephone businesses and were not based on revenue projections of the subject cellular telephone businesses' expected future financial operating results. The appraisal reports failed to elaborate specifically with respect to exactly how comparable these other cellular telephone businesses were to the subject businesses.[4] As indicated above, the subject businesses' cellular telephone systems still required further extensive

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[4] Each of the appraisal reports stated, in pertinent part:

> The subscriber and financial projections presented in this report and used to value * * * [the subject cellular telephone business] are intended to reflect mean expectations in the marketplace. These projections are based on information contained in financial analyses of the industry and the expectations implied by recent comparable sales. These assumptions may differ from projections made for operational purposes. The projections presented in this report therefore include both the current industry results and the significant upside potential of the industry.

construction work.[5] Moreover, while the Washington cellular telephone business was appraised to be worth in excess of $8.25 million, BMCT, in late 1990, had contracted to purchase this business for approximately $3.6 million following arm's-length negotiations between BMCT and the seller, an unrelated party. See note 3, *supra* p. 26. The record does not show that the Washington cellular telephone business appreciated greatly in value shortly after BMCT purchased it in late 1990. Additionally, as indicated above, Kyle sold 46-percent stock interests in BMCT and FiberComm, the two corporations that owned the two businesses, to Rhys for $61,000 apiece in late December 1991. Kyle testified that the price paid to him by Rhys for the FiberComm shares represented "what a willing buyer would have paid a willing seller".

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[5] An explanatory note to the Dec. 31,1991, financial statements of BMCT, L.P., stated, in pertinent part:

> Operations
> BMCT, L.P. is principally engaged in the ownership and operation of cellular telephone systems. The Company has been in a start-up phase in which its activities have primarily concentrated on the acquisition of cellular licenses and the construction and initial operation of cellular systems. As a result, the Company has experienced substantial net losses and has had insufficient internally generated funds to cover capital and operating expenditures and debt service. Management anticipates that it will continue to incur substantial losses and will not be able to generate sufficient cash from operations to meet expenditure requirements over the next few years.

J. Certain Legal Expenses Which NITCO Paid

During the years in issue, NITCO paid substantial fees to various attorneys and law firms in connection with certain legal proceedings and other legal matters. Most of the legal expenses that are in dispute between the parties are attributable to proceedings that were commenced before the FCC in 1983, concerning whether NICATV (the cable television company Rhys owned) was an affiliate of NITCO or are attributable to subsequent related legal proceedings that were brought as a result of the FCC proceedings.

Divestiture Action

On October 13, 1983, another cable television company that was a competitor of NICATV filed a complaint with the FCC against Rhys Mussman d/b/a NICATV and NITCO. The complaint alleged that NICATV and NITCO were affiliated companies engaged in discriminatory and anticompetitive conduct in violation of the Communications Act and the FCC's telephone company/cable television company cross-ownership rules.[6] In its complaint, the other cable television company sought damages and a cease and desist order against NICATV and NITCO.

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[6] The FCC's cross-ownership rules generally prohibited a local telephone company from offering cable television services to the viewing public within its telephone service area, either directly or indirectly through an affiliated company. The FCC's rules broadly defined affiliation to include any financial or business relationship between the telephone company and the cable television company, except the common carrier-user relationship.

On March 18, 1985, the FCC, after concluding that NICATV and NITCO were affiliated companies and that they had violated the FCC's cross-ownership rules, ordered NICATV and NITCO to: (1) Divest all cable television facilities constructed in violation of the FCC's rules and terminate all improper affiliations between NICATV and NITCO, and (2) undertake to negotiate a good faith settlement of the cable television company-complainant's claim for damages. The FCC further proposed to impose a $20,000 fine against NITCO. On August 13, 1985, the FCC denied NITCO's motion for reconsideration and reaffirmed its prior March 12, 1985, order.

In November 1985, NICATV and NITCO concluded a settlement with the cable television company-complainant that disposed of the complainant's claim against them. The FCC, however, declined to terminate the proceedings and rescind its prior orders requiring NICATV and NITCO to divest themselves of the cable television facilities.

Until about 1990, NITCO and NICATV continued to dispute the validity of the FCC orders requiring a divestiture of the cable television facilities. At various times during the period from August 1985 through 1990, they sought to have the FCC's actions reviewed and invalidated by the United States Court of Appeals for the District of Columbia Circuit and the United States Supreme Court. Ultimately, the Court of Appeals upheld the FCC's actions, and the Supreme Court denied NITCO and NICATV's petition for a writ of certiorari. See *Northwestern Ind. Tel. Co. v. FCC*, 872 F.2d 465 (D.C. Cir. 1989), cert. denied 493 U.S. 1035-1036 (1990). These proceedings involving NICATV and NITCO before the FCC, the Court

of Appeals for the District of Columbia Circuit, and the Supreme Court, are collectively referred to for convenience as the divestiture action.

Enforcement Action

During 1985 and 1986, after learning that NICATV and NITCO were commencing appellate proceedings to have the FCC's 1985 orders reviewed by the Court of Appeals for the District of Columbia Circuit, the FCC offered to them the option of placing the alleged unlawfully constructed cable television facilities in trust, pending the outcome of the appellate proceedings. NICATV and NITCO, however, were unable to reach an agreement with the FCC concerning such a trust, as the FCC, among other things, proposed that any appreciation in the cable television facilities, during the period that the facilities were held in the trust, be contributed to charity if the FCC's position were sustained. The Court of appeals for the District of Columbia Circuit subsequently declined NICATV and NITCO's request to have the FCC orders stayed. When NICATV and NITCO further declined to divest themselves of the cable television facilities, the FCC referred the matter to the Department of Justice for purposes of enforcing the FCC's divestiture orders against NICATV and NITCO.

In early 1987, the United States brought suit against NICATV and NITCO in the United States District Court for the Northern District of Indiana for enforcement of the FCC's divestiture orders. These proceedings before the District Court are referred to for convenience as the enforcement action.

Constitutional Challenge Action

During the course of the above divestiture action, NICATV and NITCO later tried to raise certain issues with respect to the constitutionality of the Communications Act and the FCC's cross-ownership rules. The FCC and the Court of Appeals for the District of Columbia Circuit, however, essentially held that these constitutional issues were not properly before them. *Northwestern Ind. Tel. Co. v. FCC*, 872 F.2d at 471-472.

On March 24, 1988, Rhys and NITCO filed a declaratory judgment action against the FCC in the United States District Court for the Northern District of Indiana, requesting that the District Court declare unconstitutional an FCC cross-ownership rule imposed against Rhys. In the complaint, it was alleged that Rhys wished to buy shares of stock in NITCO from Mr. Mussman, but was unable to do so under the FCC's cross-ownership rules, in light of his ownership of NICATV. These proceedings before the District Court are referred to for convenience as the constitutional challenge action.

Attribution of Legal Expenses NITCO Incurred and/or Paid to Various Legal Proceedings and Other Legal Matters

During 1987 and 1988, the attorneys's fees in issue, that NITCO incurred and/or paid to the law firm of Baker & Hostetler (B&H), were attributable to the following legal proceedings and other legal matters:

Year	Amount	Proceedings or Matter
1987	$2,762.65	AT&T negotiations
	1,500.00	Constitutional challenge action
	4,337.50	Dial One Mobile
	130.00	Divestiture action
	172,756.85	Enforcement action
	1,000.00	NITCO business plan
1988	2,500.00	AT&T negotiations
	15,959.48	Constitutional challenge and divestiture action
	3,022.96	Dial One Mobile
	7,009.89	RSA #1
1989	10,117.80	Postal Service Investigation
	1,365.44	Unknown

Respondent concedes that the above fees paid to B&H for AT&T negotiations and the NITCO business plan are deductible by NITCO. The Dial One Mobile matters concerned the company that Rhys owned, which was engaged in activities with respect to cellular telephone systems in Asheville, North Carolina, and Enid, Oklahoma. NITCO had no interest in Dial One Mobile. The Postal Service investigation involved a matter in which certain documents and records of NICATV's were seized from NICATV's business offices.

During 1987, 1988, and 1989, the attorney's fees in issue, that NITCO incurred and/or paid to the law firm of LMN&G, were attributable to the following legal proceedings and other legal matters:

Year	Amount	Proceeding or Matter
1987	$169,686.00	Constitutional challenge, divestiture, and enforcement actions
	5,000.00	Unknown
1988	98,212.00	Constitutional challenge, divestiture, and enforcement actions
	1,000.00	Dial One USA trademark
	38,020.00	RSA #1
	1,400.00	Unknown
1989	214,201.00	Constitutional challenge, divestiture, and enforcement actions
	5,393.00	Dial One USA
	31,249.00	RSA #1
	32,240.00	Sprint contract
	14,650.00	Unknown

The Sprint work referred to above concerned the negotiation of a contract between Dial One USA and Sprint.

During 1988 and 1989, NITCO incurred and/or paid to the law firm of Williams & Connolly (W&C) attorney's fees that were attributable to the following legal proceedings and other legal matters:

Year	Amount	Proceeding or Matter
1988	$32,144.50	Constitutional challenge action
1989	13,742.45	Constitutional challenge action
	2,239.85	Dial One Mobile

The Dial One Mobile work listed above was billed by W&C to Rhys, not to NITCO. Petitioners concede that the

$2,239.85 is not deductible by NITCO and represents constructive dividend income to Mr. Mussman.

During 1989, NITCO made certain legal expenditures totaling $88,484, for which it claimed no deduction. A portion of these expenditures in the amount of $75,342 was recorded by NITCO in an account called "Cellular Telephone Investment". The remaining $13,052 of the expenditures was recorded by NITCO in an account called "Other Investments". The $88,484 in legal expenditures was attributable to the following matters:

Payee	Amount	Matter
Andrew & Kurth	$1,166.59	Dial One Mobile
B&H	32,363.64	Dial One Mobile
EMCI	3,327.50	Purchase of cellular telephone publications
Handlon & Handlon	1,525.81	Work for Dial One USA and Intelcom
	132.00	Work for FiberComm
	229.00	Unknown
	234.00	Incorporation of Northwestern Indiana Cellular
LMN&G	2,982.58	Work for Rhys
	2,564.05	Indiana RSA #1 venture
	4,400.00	Conceded by petitioners to be constructive dividend to Mr. Mussman
Unknown	39,968.83	Unknown

On the record presented in the instant cases, it is not clear whether the purchase of cellular publications referred to above furthered NITCO's interests and was of direct and

substantial benefit to NITCO or, instead, was primarily of benefit to individual members of the Mussman family. The Northwestern Indiana Cellular matter referred to above concerned a corporation that was originally formed to hold cellular telephone interests, but which subsequently was abandoned. It is not clear whether Mr. Mussman planned to have NITCO, rather than the individual members of the Mussman family, own Northwestern Indiana Cellular, and whether Mr. Mussman planned to have it hold cellular telephone interests that NITCO, rather than individual members of the Mussman family, owned.

K. NITCO's Earnings and Dividend Payment History, Current Liquid Assets, Working Capital Needs, and Records Documenting Its Specific Future Business Needs and Plans

NITCO maintained its books and filed its income tax returns on a calendar year basis, utilizing an accrual method of accounting. During 1982 through 1993, NITCO's gross receipts and its accumulated earnings and profits (Accum. E&P) were as follows:

Year	Gross Receipts	Accum. E&P	Yearly Increase In Accum. E&P
1982	$3,172,182	$ 3,176,521	–
1983	3,684,425	3,929,694	753,173
1984	4,247,606	4,895,862	966,168
1985	4,019,355	5,406,973	511,111
1986	4,575,760	6,240,031	833,058
1987	5,754,822	7,807,835	1,567,804
1988	6,134,837	9,226,900	1,419,065

1989	5,281,159	9,939,632	712,732
1990	6,305,070	11,675,809	1,736,177
1991	6,860,119	12,688,043	1,012,234
1992	7,780,380	14,544,105	1,856,062
1993	8,726,683	15,250,005	705,900

During 1987 through 1989, NITCO's current assets consisted mostly of cash or other liquid assets. Its customer accounts receivable and National Exchange Carriers Association accounts receivable (i.e., long-distance call access charges) were billed monthly.

During 1987 through 1989, NITCO's net current liquid assets, as adjusted by two loans it made, respectively, to a local Indiana bank's employee stock option plan and to the bank's president,[7] and if not depleted by certain payments it made to support the individual Mussman family members during these years, would have been as follows:

Year	Net Current Liquid Assets
1987	$5,183,131
1988	4,726,973
1989	4,455,217

NITCO's working capital requirements for 1987, 1988, and 1989, were $75,569, $278,646, and $190,312, respectively.

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[7] After its renegotiation in August 1987, the ESOP loan essentially was required to be repaid to NITCO on NITCO's demand. The $400,000 loan to the bank president occurred on June 15, 1987, and was made out of a loan repayment NITCO received from the ESOP. Although a promissory note bearing a December 1988 execution date was later issued by the bank president, the note obligated the bank president to repay the $400,000 loan to Mr. Mussman, rather than to NITCO, in 4 years.

From 1980 through 1989, NITCO maintained no written records documenting its specific future business needs and plans.

From 1954 through 1994, NITCO did not declare and pay any formal dividends to its shareholders.

L. Examinations Conducted of Petitioners' Returns, Notices of Deficiency, NITCO's Petition, and Subsequent Formal Discovery Conducted by Respondent in the Instant Cases

On or about August 3, 1990, a revenue agent contacted and apprised Mr. Mussman and NITCO that the agent would be conducting an examination. In an Information Document Request dated October 31, 1990, to NITCO, the revenue agent, among other things, asked NITCO to elaborate with respect to its plans concerning the use of its accumulated earnings. The agent's request, in pertinent part, stated:

> 1. During my first visit, you enumerated the following potential uses of the company's retained earnings:
>
> At the present time, the Company is involved in expansion:
>
> (1) The Company has a plan to introduce fiberoptics to its system. Engineering estimates have not been made for the system.
>
> (2) The Company is developing a cellular telephone capability for the area. This area is a RSA, Rural Statistical Area. This development is being shared with two other companies, Monan and Pulaski-White. However, the family members, not the Company, made the investment.

> (3) The Company would like to acquire the Monan telephone exchange. There have been negotiations but nothing has been put in writing about this. The Company is closely held. As a result, there are no formal annual meetings or minutes.
>
> Are there any other planned uses of these funds?

On or about December 12, 1990, two MW&E attorneys advised the revenue agent that they would be representing NITCO during the examination. By letter dated December 17, 1990, one of the MW&E attorneys further advised the revenue agent, among other things: (1) NITCO had not yet completed its review of the planned uses for its accumulated earnings, and (2) NITCO was not willing to consent to an extension of the period of limitations on assessment and collection of its tax liability with respect to 1987. The MW&E attorney's December 17, 1990, letter, in pertinent part, stated:

> You have also asked the company to identify the potential uses of net liquid assets [and accumulated earnings]. We have recently been retained by the company for purposes of this representation and are in the process of reviewing the corporate documentation and interviewing the officers. When that process has been completed, we will provide you with a full statement concerning the historic purposes for accumulating net liquid assets [and earnings]. Although the process is far from complete, the list included in your [October 31, 1990] document request overlooks the largest and most obvious need for net liquid assets. That is, the preservation of financial strength to cope with

> the uncertainty present in the telecommunications industry during the period under audit. Those uncertainties concern technical developments and regulatory governance and management succession.
>
> As counsel to the company, we have advised them not to extend the statute of limitation for the year 1987 for purposes of audit. While we generally recommend extensions of the statute for purposes of appellate review of a case, we do not recommend extension of the statute for purposes of audit. In our view, the time pressure you face for the year 1987 is the product of your (or your supervisor's) decision to open 1987 with so little time remaining on the statute.

Respondent subsequently notified NITCO of the proposed determination against NITCO with respect to accumulated earnings tax liability for 1987, 1988, and 1989. NITCO chose not to respond and did not file a statement concerning the grounds on which it relied to establish that its earnings were accumulated to meet its reasonable business needs.[8]

In April 1991, respondent issued respective notices of deficiency to Mr. and Mrs. Mussman for 1988 and 1989, and to NITCO for 1987, 1988, and 1989. With respect to the accumulated earnings tax liability asserted against NITCO, the notice of deficiency issued to NITCO stated, in pertinent part:

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[8] As a result, in the instant cases, NITCO has the burden of proof in establishing that it is not liable for the accumulated earnings tax liabilities determined against it by respondent in the notice of deficiency. See sec. 534(a)(2).

10 (b.) *Section 531 Tax*

It is determined that you were availed of for the purpose of avoiding the income tax with respect to your shareholders by permitting earnings and profits to accumulate instead of being divided or distributed during the taxable years 1987, 1988, and 1989. Accordingly, the accumulated earnings tax provided by Section 531 of the Internal Revenue Code is being asserted for 1987, 1988, and 1989. In determining your accumulated earnings credit under the provisions of section 535 of the Internal Revenue Code, your failure or refusal to respond to the notification sent to you by certified mail on January 15, 1991 pursuant to [section] 534(b) explaining the capital needs of your business has been considered. Therefore, accumulated earnings tax is increased $540,044.00, $322,147.00, and $195,917.00, respectively for the tax years ended December 31, 1987, December 31, 1988, and December 31, 1989. * * *

The notice of deficiency indicated that respondent computed NITCO's above 1987, 1988, and 1989 accumulated earnings tax liabilities as follows:

	1987	1988	1989
Taxable income as adjusted	$1,431,283.00	$1,150,524.00	$699,703.00
Less dividends	0.00	0.00	0.00
Current earning and profits retained	1,431,283.00	1,150,524.00	699,703.00
Accumulated earnings Credit			
1. Minimum accumulated earnings allowed	250,000.00	–	250,000.00
2. Less accumulated earnings as of the close of the preceding taxable year	(6,240,031.45)	(7,800,101.00)	(9,266,900.00)
3. Reduced by dividends considered paid during preceding taxable year	0.00	0.00	0.00
4. Allowable credit	0.00	0.00	0.00
5. Current earnings and profits determined to be retained for reasonable needs of the business	0.00	0.00	0.00
6. Less: deduction for long-term capital gains	0.00	–	–
7. Allowable credit under IRC sec. 535(c)(1)	0.00	0.00	0.00
Accumulated earnings credit (greater of item 4 or item 7)	0.00	0.00	0.00
Accumulated taxable income subject to tax	$1,431,283.00	$1,150,524.00	$699,703.00
Tax on accumulated earnings	540,044.00	322,147.00	195,916.84

Petitioners subsequently filed their respective petitions commencing the instant cases. In its petition, NITCO did not allege any specific business needs for which it was accumulating its earnings.

During pretrial discovery, on March 4, 1992, respondent propounded certain interrogatories to NITCO asking it to elaborate fully with respect to the alleged specific business needs for which NITCO contended it was accumulating its earnings during 1987 through 1989. In its April 17, 1992, response to the interrogatories, NITCO generally objected to having to answer the interrogatories and declined to provide the information respondent sought, except that in partial response to some of the interrogatories, NITCO referred to an April 8, 1992, memorandum concerning NITCO's reasonable business needs that had been prepared by NITCO'S counsel and that recently had been furnished by NITCO's counsel to respondent's Appeals officer. The April 8, 1992, memorandum provided to the Appeals officer stated:

> This is a summary of the items we intend to rely on as justification of * * * NITCO's accumulation of working capital [and earnings] for years 1987 through 1989. It is based upon documents we have reviewed and discussions we have had to date with NITCO personnel and outside advisors (including NITCO's accountant, outside counsels [sic] and independent telephone industry consultants).

The memorandum did not indicate that NITCO, during the years in issue, planned to: (1) Replace its Alcatel

switches, (2) acquire SS7 signaling technology,[9] (3) offer CLASS services,[10] (4) save in order to provide increased local telephone services in the event the proposed Indiana airport was built in or near NITCO's service area, (5) save for expansion of NITCO's principal office facilities, or (6) purchase a computer to meet its alleged office equipment needs. Subsequently, on August 4, 1992, the Court granted respondent's motion to compel NITCO to answer the interrogatories and issued an order requiring NITCO to answer the interrogatories on or before September 4, 1992.

It was not until about December 1992 that NITCO first advised respondent of its alleged plans, during the years in issue, to: (1) Save in order to provide increased telephone services in the event the proposed Indiana airport was built, and (2) save for an expansion of its principal office facilities. Similarly, it was not until November 1993 that NITCO first advised respondent that its alleged office equipment needs during the years in issue included a billing and collections computer.

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[9] SS7 signaling technology uses a data network separate from the voice network to carry information about telephone call setup and accounting.

[10] CLASS services are a group of telecommunication services consisting of selective call forwarding, selective call rejection, distinctive ringing, customer originated trace, automatic callback, automatic recall, and calling number delivery and calling number delivery blocking.

OPINION

Petitioners bear the burden of proof and must establish that the determinations made in respondent's notices of deficiency are erroneous. Rule 142(a); *Welch v. Helvering*, 290 U.S. 111 (1933).

I. Accumulated Earnings Tax

Section 532(a) provides that every corporation formed or availed of for purposes of avoiding the income tax with respect to its shareholders, by permitting earnings and profits to accumulate instead of being divided or distributed, shall be subject to the accumulated earnings tax imposed by section 531. The accumulated earnings tax is a way of discouraging corporations from accumulating earnings not needed in conducting the business. *Snow Manufacturing Co. v. Commissioner*, 86 T.C. 260, 268 (1986). The tax is considered to be a penalty and, therefore, is to be strictly construed. *Ivan Allen Co. v. United Stares*, 422 U.S. 617, 626 (1975); see generally *Technalysis Corp. v. Commissioner*, 101 T.C. 397, 402-403 (1993).

The most important factor in deciding if the accumulated earnings tax applies is whether a corporation accumulates earnings and profits beyond the reasonable needs of the business. *United States v. Donruss Co.*, 393 U.S. 297, 307 (1969). Section 533(a) establishes a presumption that a corporation that permits earnings and profits to accumulate beyond the reasonable needs of the business does so with the purpose of avoiding income tax with respect to its shareholders.

The presumption can be rebutted by a preponderance of evidence to the contrary. Sec. 533(a); *Snow Manufacturing Co. v. Commissioner, supra* at 269. Therefore, the accumulated earnings tax does not apply if a corporation has allowed an unreasonable accumulation but lacks the proscribed purpose or intent. *Technalysis Corp. v. Commissioner, supra* at 403; *Pelton Steel Casting Co. v. Commissioner*, 28 T.C. 153, 173 (1957), affd. 251 F.2d 278 (7th Cir. 1958). However, it has been recognized that without the presumption provided in section 533(a), the accumulated earnings tax would largely, as a practical matter, be unenforceable. *Ivan Allen Co. v. United States, supra* at 628.

Section 1.533-1(a)(2), Income Tax Regs., sets forth factors to be considered in determining whether a corporation had the proscribed purpose. Some of the relevant factors are: (1) Dealings between the corporation and its shareholders for the personal benefit of the shareholders; for example, personal loans; (2) corporate investment of undistributed assets in unrelated businesses or investments; and (3) the corporation's dividend history.

Section 535(a) defines "accumulated taxable income" (the recomputed taxable income of the corporation against which tax under section 531 is imposed) as the taxable income of the corporation, as adjusted in section 535(b), less the dividend-paid deduction (as defined in section 561) and the accumulated earnings credit (as defined in section 535(c)). Insofar as relevant to the instant cases, this accumulated earnings credit is the amount of the corporation's earnings and profits that are retained for the reasonable needs of the business. Where a taxpayer can show that all its current earnings were

accumulated for the reasonable needs of the business, there is no accumulated earnings tax since the accumulated earnings credit eliminates the amount against which the tax is imposed. E.g., *Magic Mart, Inc. v. Commissioner*, 51 T.C. 775, 799 (1969); *Faber Cement Block Co. v. Commissioner*, 50 T.C. 317, 336 (1968); *John P. Scripps Newspapers v. Commissioner*, 44 T.C. 453, 474 (1965).

Whether a taxpayer's accumulation of earnings and profits is in excess of its reasonable business needs is a factual question. *Helvering v. National Grocery Co.*, 304 U.S. 282 (1938). The "reasonable needs of the business" includes the reasonably anticipated needs of the business. Sec. 537(a)(1); sec. 1.537-1(a). Income Tax Regs.

With respect to a corporation's reasonably anticipated future business needs, section 1.537-1(b), Income Tax Regs, provides:

> (b) *Reasonably anticipated needs.* (1) In order for a corporation to justify an accumulation of earnings and profits for reasonably anticipated future needs, there must be an indication that the future needs of the business require such accumulation, and the corporation must have specific, definite and feasible plans for the use of such accumulation. Such an accumulation need not be used immediately, nor must the plans for its use be consummated within a short period after the close of the taxable year, provided that such accumulation will be used within a reasonable time depending upon all the facts and circumstances relating to the future needs of the business. Where the future needs of the business are uncertain or vague, where the plans for the future use of an accumulation are not specific, definite, and feasible, or where the

> execution of such a plan is postponed indefinitely, an accumulation cannot be justified on the grounds of reasonably anticipated needs of the business.
>
> (2) Consideration shall be given to reasonably anticipated needs as they exist on the basis of the facts at the close of the taxable year. Thus, subsequent events shall not be used for the purpose of showing that the retention of earnings or profits was unreasonable at the close of the taxable year if all the elements of reasonable anticipation are present at the close of such taxable year. However, subsequent events may be considered to determine whether the taxpayer actually intended to consummate or has actually consummated the plans for which the earnings and profits were accumulated. * * *

Upon determining the amount necessary to satisfy the "reasonable needs of the business", we shall not simply compare this amount with the corporation's total accumulated earnings and profits, but shall examine the amount of accumulated earnings and profits that is reflected in business-related assets or in idle net liquid assets of the corporation. *Ivan Allen Co. v. United States, supra* at 628; *Smoot Sand & Gravel Corp. v. Commissioner*, 274 F.2d 495, 501 (4th Cir. 1960), affg. T.C. Memo. 1958-221. In other words, we must consider whether the corporation's accumulated earnings and profits have been translated into assets related to the business, so as to have been employed to meet the corporation's reasonable business needs. In *Smoot Sand & Gravel Corp. v. Commissioner*, 274 F.2d at 500-501, the Court of Appeals for the Fourth Circuit explained:

> the size of the accumulated earnings and profits or surplus is not the crucial factor; rather, it is the reasonableness and nature of the surplus. * * * Again, to the extent the surplus has been translated into plant expansion, increased receivables, enlarged inventories, or other assets related to its business, the corporation may accumulate surplus with impunity. * * *

In *Ivan Allen Co. v. United States, supra,* the taxpayer had substantial accumulated earnings and profits and owned certain readily marketable securities that had considerably appreciated in value. The issue presented to the Supreme Court was whether in determining the applicability of the rebuttable presumption provided in section 533(a) (i.e., whether the taxpayer's earnings had accumulated beyond the reasonable needs of the business so that the taxpayer should be presumed to have the purpose to avoid income with respect its shareholders), the taxpayer's securities were to be taken into account at their cost to the corporation or at their net liquidation value. *Id.* at 619.

In holding that the securities were to be taken into account at their net liquidation value, rather than cost, the Supreme Court recognized that a comparison of the taxpayer's liquidity to its business needs was highly significant in deciding the reasonableness of the taxpayer's accumulation of earnings. It explained:

> It is important to emphasize that we are concerned here with a tax on "accumulated taxable income," § 531, and that the tax attaches only when a corporation has permitted "earnings and profits to accumulate instead of being

divided or distributed," § 532(a). What is essential is that there be "income" and "earnings and profits." This at once eliminates, from the measure of the tax itself, any unrealized appreciation in the value of the taxpayer's portfolio securities over cost, for any such unrealized appreciation does not enter into the computation of the corporation's "income" and "earnings and profits."

The corporation's readily marketable portfolio securities and their unrealized appreciation, nonetheless, are of profound importance in making the entirely discrete determination whether the corporation has permitted, what, concededly, are earnings and profits to accumulate beyond its reasonable business needs. If the securities, as here, are readily available as liquid assets, then the recognized earnings and profits that have been accumulated may well have been unnecessarily accumulated, so far as the reasonable needs of the business are concerned. * * * Upon this analysis, not only is such accumulation as has taken place important, but the liquidity otherwise available to the corporation is highly significant. In any event – and we repeat – the tax is directed at the accumulated taxable income and at earnings and profits. The tax itself is not directed at the unrealized appreciation of the liquid assets in the securities portfolio. The latter becomes important only in measuring reasonableness of accumulation of the earnings and profits that otherwise independently exist. What we look at, then, in order to determine its reasonableness or unreasonableness, in the light of the needs of the business, is

> any failure on the part of the corporation to distribute the earnings and profits it has.

Ivan Allen Co. v. United States, 422 U.S. at 627-628.

> What is required, then, is a comparison of accumulated earnings and profits with "the reasonable needs of the business." Business *needs* are critical. And need, plainly, to use mathematical terminology, is a function of a corporation's liquidity, that is, the amount of idle current assets at its disposal. The question, therefore, is not how much capital of all sorts, but how much in the way of quick or liquid assets, it is reasonable to keep on hand for the business. * * *
>
> The taxpayer itself recognizes, and accepts, the liquidity concept as a basic factor, for it "has agreed that the full amount of its realized earnings invested in its liquid assets – their cost – should be taken into account in determining the applicability of Section 533(a)." * * * It concedes that if this were not so, "the tax could be avoided by any form of investment of earnings and profits." * * * But the taxpayer would stop at the point of cost and, when it does so, is compelled to compare earnings and profits – not the amount of readily available liquid assets, net – with reasonable business needs.
>
> We disagree with the taxpayer and conclude that cost is not the stopping point; that the application of the accumulated earnings tax, in a given case, may well depend on whether the corporation has available readily marketable portfolio securities; and that the proper measure of those securities, for purposes of the tax, is their net realizable value. Cost of the marketable securities on the assets side of the corporation's

> balance sheet would appear to be largely an irrelevant gauge of the taxpayer's true financial condition. Certainly, a lender would not evaluate a potential borrower's marketable securities at cost. Realistic financial condition is the focus of the lender's inquiry. It also must be the focus of the Commissioner's inquiry in determining the applicability of the accumulated earnings tax.
>
> This taxpayer's securities, being liquid and readily marketable, clearly were available for the business needs of the corporation, and their fair market value, net, was such that, according to the stipulation, the taxpayer's undistributed earnings and profits for the two fiscal years in question were permitted to accumulate beyond the reasonable and reasonably anticipated needs of the business.

Ivan Allen Co. v. United States, 422 U.S. at 629-630 (fn. refs. omitted.)

NITCO's Net Liquid Assets

Petitioners contend that NITCO's accumulated earnings and profits are "irrelevant" and that only NITCO's net liquid assets should be considered in connection with NITCO's reasonable business needs and its liability for accumulated earnings tax during the years in issue. They argue that the accumulated earnings tax is directed at "economic reality" and that this relevant economic reality (NITCO's dividend-paying capacity) is to be determined solely by examining NITCO's available net liquid assets.

Respondent, on the other hand, asserts that NITCO's true dividend-paying capacity is not accurately reflected

by NITCO's remaining net liquid assets, because of NITCO's substantial expenditures, during 1987 through 1989, for the personal benefit of Mr. Mussman's family. We agree with respondent.

We have no quarrel with, and the case law completely supports, the proposition that where a corporation's net liquid assets have been invested in nonliquid, business-related assets, the corporation has appropriately diminished its dividend-paying capacity for accumulated earnings tax purposes. In such instances, the corporation's accumulated earnings have been applied to meet its reasonable business needs. However, this is not the same situation that we are presented with in the instant cases.

In our findings, we have made certain adjustments to reflect what NITCO's net liquid assets would have been (i.e., its true dividend-paying capacity), during the years in issue, if NITCO had not made certain nonbusiness-related payments to benefit the individual Mussman family members.[11] These expenditures did not further

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[11] Petitioners, on the other hand, contend that for 1987, 1988, and 1989, NITCO's net liquid assets were as follows:

Year	Net Liquid Assets
1987	$3,190,325
1988	4,251,470
1989	3,991,669

We note that even these respective amounts of net liquid assets well exceed the current earnings that NITCO accumulated during each of these years. We are further aware that to the extent we sustain respondent's determinations with respect to the Mussmans' having constructive dividend income for the years in issue, there will be a resulting decrease in NITCO's

NITCO's business interests and were not of substantial and direct benefit to NITCO.

Petitioners' arguments in this connection misapply and misinterpret the pertinent case law. NITCO's remaining net liquid assets do not reflect its true dividend-paying capacity because of substantial nonbusiness-related expenditures it made. Indeed, many of these expenditures may have been constructive dividends to Mr. Mussman. These expenditures do not represent translations of NITCO's accumulated earnings into assets related to the conduct of NITCO's business. Cf. *Smoot Sand & Gravel Corp. v. Commissioner*, 274 F.2d at 501. In other words, rather than being positive evidence demonstrating that NITCO's earnings were, in fact, accumulated to meet its reasonable business needs, these expenditures indicate NITCO's earnings were accumulated for the proscribed purpose of avoiding income tax with respect to its shareholders. See sec. 1.533-1(a)(2), Income Tax Regs. To accept petitioners' contention would be tantamount to holding that the accumulated earnings tax could be avoided by making nonbusiness expenditures to benefit a shareholder or shareholder's family.

NITCO's Reasonable Business Needs

The parties have stipulated, and we have so found, what NITCO's working capital requirements were during the years in issue. In addition to these working capital requirements, petitioners contend that a number of other

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accumulated taxable income and current earnings. See secs. 535(a), (c)(1); 301(c)(1); 316(a).

reasonably anticipated business needs of NITCO justified NITCO's accumulation of earnings during the years in issue.[12]

Respondent generally disputes that NITCO, during 1987 through 1989, had the reasonable business needs that petitioners allege. Respondent agrees with the working capital requirements and agrees that, for 1987, NITCO

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[12] Petitioners contend that NITCO's "reasonably anticipated business needs" during the years in issue were as follows:

Business Need	1987	1988	1989
Working capital	$75,569	$278,646	$190,312
Retirement of long-term debt	557,505	170,760	-0-
Plant modernization:			
Fiber to the exchange	1,000,000	same	same
Fiber optic cable to support broadband	500,000 1,000,000	same same	same same
Switches for SS7/Class	6,000,000-10,000,000	same	same
Broadband switch	8,000,000-20,000,000	same	same
Telephone acquisition	1,000,000-5,000,000	same	same
Airport risk:			
In NITCO's exchange	300,000,000	same	same
Near NITCO's exchanges	25,000,000-50,000,000	same	same
Cellular diversification	2,000,000-2,500,000	same	same
Billings & collections computer	850,000-1,000,000	same	same
Building expansion; furnished	2,000,000-2,500,000	same	same

needed $669,530 to retire its long-term debt on the old switching equipment it replaced. Respondent further agrees that NITCO's reasonable business needs required the accumulation of some earnings to install fiber optic cable between its exchanges, but contends that petitioners have failed to offer convincing evidence establishing the precise amount. Respondent contends that NITCO, during the years in issue, had no actual definite plans with respect to meeting the other alleged business needs and that those alleged needs were not reasonably anticipated business needs of NITCO. We generally agree with respondent.

In evaluating what NITCO's reasonable business needs were during the years in issue, we have been faced with a lack of forthrightness on Petitioners' part. For instance, Mr. Mussman testified that, during 1987 through 1989, NITCO planned to replace its Alcatel switches, because the French manufacturer had decided to abandon the U.S. market and stop conducting future research and development efforts with respect to upgrading the switches. He claimed that NITCO learned of the French manufacturer's decision shortly after NITCO had purchased and installed its Alcatel switches. Yet, when questioned by respondent's counsel on cross-examination about NITCO's contrary representations concerning the switches to the IURC's engineering staff in late 1990. Mr. Mussman maintained that the statements in the August 1990 letter issued to NITCO by Alcatel's U.S. representative were untrue. Mr. Mussman, however, offered no

convincing explanation why, if NITCO knew the statements made were untrue, NITCO then had provided a copy of the letter to the IURC's staff.[13]

On the record presented, it is questionable whether during the years in issue, NITCO had actual plans concerning many of the purported business needs petitioners have alleged. NITCO produced practically nothing in terms of documents that were prepared during the years in issue that reflect its alleged plans and future needs. Indeed, we view these claimed future needs to be largely afterthoughts advanced by petitioners to avoid the imposition of accumulated earnings tax liability against NITCO. Moreover, almost all the asserted future needs are too vague and uncertain to be considered reasonably anticipated business needs of NITCO.

Additionally, considerably undercutting petitioners' position that NITCO's earnings were accumulated to meet these alleged reasonably anticipated business needs of NITCO, is the fact that, notwithstanding these alleged future needs, NITCO, in late 1990 and early 1991, loaned approximately $3.6 million to BMCT, a corporation solely owned by Mr. Mussman's son Kyle, to enable BMCT to

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[13] In another instance, Mr. Mussman testified that architectural plans of new principal office facilities for NITCO were drawn up in 1989. On cross-examination, however, he claimed that the plans were not provided to respondent during pretrial discovery, because the plans were his personal property and did not belong to NITCO. He further offered no convincing explanation with respect to why petitioners had failed to produce the alleged plans and information concerning the alleged architect who drew them in response to respondent's pretrial discovery requests.

acquire a Washington State cellular telephone business. The $3.6 million loaned was an investment unrelated to NITCO's business and was of dubious economic benefit to NITCO, considering NITCO's later agreement to subordinate its rights with respect to BMCT's repayment of the loan in order for BMCT to borrow an additional $2.8 million from another lender. Although NITCO subsequently converted its $3.6 million loan to a limited partnership interest in the BMCT limited partnership, pursuant to the advice of its attorneys following the issuances of the notices of deficiency in the instant cases, the limited partnership's formation was not an arm's-length transaction between the partners, and the limited partnership interest NITCO obtained was not commensurate with its relative capital contribution to the limited partnership.

With respect to the retirement of NITCO's long-term debt, petitioners have established that in 1988 and 1989, NITCO made respective payments of $575,505 and $170,700 to retire the debt. Although the debt's outstanding principal amount was $669,530, NITCO was required to pay some additional interest and a prepayment penalty to retire the debt.

With respect to NITCO's installation of fiber optic cable to connect its exchanges, Mr. Mussman testified that NITCO spent about $1 million to install the fiber optic cable during 1987 through 1989. On cross-examination, however, he admitted that his $1 million figure included NITCO's overhead costs, as NITCO's employees performed the installation work. Further, most of the cable to connect the exchanges was installed in 1987 and 1988. By 1989, NITCO was in the final stages of the connection

work, and only a relatively short segment of cable remained to be installed once NITCO resolved an easement problem. We think Mr. Mussman's $1 million figure is high. Petitioners offered no specific additional evidence concerning the actual amounts NITCO spent to install the fiber optic cable during 1987 through 1989. Doing the best we can on the record presented, and bearing heavily against petitioners because this inexactitude is of their own making, we estimate that the accumulation of earnings justified to meet NITCO's reasonable business need for installing fiber optic cable to connect its exchanges was $300,000 for 1987 and was $100,000 for each of the years 1988 and 1989.

With respect to broadband switches and the fiber optic cable to support broadband switches, petitioners maintain that NITCO planned to eventually acquire the broadband switches at about the time it commenced to rewire the homes of its residential customers with fiber optic cable.[14] Yet, in the white paper Kyle authored and

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[14] In a letter dated Sept. 28, 1992, to respondent's counsel that elaborated on certain of NITCO's alleged business needs, petitioners' counsel stated:

> During the years in issue * * * [NITCO] also determined that ultimately it would be required to retrowire individual housing for fiber optic cable and to move on to the next generation of digital switching. Fiber optic cable coupled with the next generation of digital switching will allow NITCO to provide service option features to its customers comparable to adjoining telephone companies such as Call blocking, caller I.D., and call-me-back services. This next generation of digital switches is generally described as broad-band switches which have the capacity for

published in 1989 while he was NITCO's general manager, Kyle was of the view that the installation of fiber optic cable in residences by local telephone companies was not then economically feasible. His paper estimated that using fiber optic cables to provide "plain old telephone service" to individual homes, at that time, would cost from $4,000 to $10,000 per residential customer.

Respondent offered the expert witness report of Dr. Charles L. Jackson and Dr. Jeffrey H. Rohlfs, each of whom has had extensive experience in the telecommunications industry. Dr. Jackson is an engineer with 25 years of experience in the computer and telecommunications industry. He has worked as a consultant for the past 13 years. Dr. Rohlfs is an economist with over 20 years experience in the telecommunications industry. He worked for 14 years at Bell Labs where he became a department head for economic modeling research and subsequently has worked for the last 10 years as a consultant.

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greater programming flexibility in order to provide multiple services to each line. While no copper wire in existing residential and commercial installation has been retrofitted with fiber optic cable to date to allow use of the new generation switches, such program is anticipated in the near future to enable NITCO to remain competitive.

These broadband switches apparently could also be used to provide television or video services to customers. On reply brief, petitioners state that they are not contending that "NITCO * * * sought to provide wideband (video) services in 1987 to 1989, only that it saw a need * * * to provide video services in the mid to late 1990s to meet the threat of competition from cable companies."

Drs. Jackson and Rohlfs were of the opinion that, as of 1989, vast uncertainty existed about the future cost and availability of systems that would provide fiber connections to residential customers.[15] They further opined that it would be a number of years before it was economically justifiable for NITCO even to consider seriously investing in the technology to provide broadband switch services over fiber lines to its business and residential customers. They noted that during 1987 through 1989, NITCO had few, if any, business customers who would demand such services.

Petitioners offered the expert witness opinion of Warren A. Liss. Mr. Liss has extensive experience in the telecommunications industry. He has held a variety of management positions involving the design and development of telephone switching hardware and software, telephone networks, and telecommunications services. He worked for over 20 years at Bell Labs and then was employed as a director of advanced systems engineering at MCI Telecommunications. Since 1987, he has worked as a consultant to various local, long distance, and international telephone service companies.

Mr. Liss was of the opinion that the wideband switch services now currently offered to certain businesses, hospitals, schools, and other institutions, would inevitably

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[15] According to Drs. Jackson and Rohlfs, during 1987 through 1989, experts in their field were predicting that, in the telephone service industry as a whole, by the end of the century there would be a 10-to-20 percent penetration of fiber optic technology into the "cooper loop" that connects customers to telephone company networks.

migrate to residential applications. He noted that the FCC's recent "Video Dial Tone" ruling removed certain regulatory restrictions that prevented telephone companies from entering that business area. He opined that, although the time frame could not be well defined, it could take 5 to 10 years for serious penetration of the residential market for broadband switch services to occur.

The above expert opinions of Drs. Jackson and Rohlfs and Mr. Liss, along with the 1989 white paper Kyle authored, reflect that, during 1987 through 1989. NITCO's rewiring of residences with fiber optic cable and its purchase of broadband switches, would only become economically justified following the occurrence of future commercial, legal, and technological developments that would permit NITCO to derive substantial additional revenue from offering new services, such as television services, over fiber optic lines. NITCO's plans to employ broadband switches could hardly be considered to be specific and definite during the years in issue. We conclude that NITCO's future needs to install broadband switches and the fiber optic cable to support such switches, were too vague and uncertain to be reasonably anticipated business needs of NITCO during 1987 through 1989. Sec. 1.537-1(b)(1). Income Tax Regs.

Similarly, we are not convinced that NITCO, during 1987 through 1989, had any actual plans with respect to SS7/Class switches, "Airport risk", a billing and collections computer, and headquarters building expansion. As indicated above, we think that these purported business needs are mere afterthoughts on petitioners' part, rather than actual future needs that NITCO anticipated and planned to meet during 1987 through 1989. It was not

until late 1992 and 1993 that petitioners first advised respondent's counsel that these asserted needs were among NITCO's alleged reasonable business needs. Moreover, these asserted future needs were too vague and uncertain to be considered reasonably anticipated business needs of NITCO during 1987 through 1989. Sec. 1.537-1(b)(1), Income Tax Regs.

With respect to possible telephone company acquisition and cellular telephone diversification, the record is not clear whether Mr. Mussman intended to have NITCO or individual members of the Mussman family, undertake and benefit from such activities or ventures. Although NITCO applied for a cellular telephone license with respect to the Indiana RSA #1 area in 1988, the record reflects that Mr. Mussman's plan and intention was to transfer the cellular telephone license rights that were obtained to Serv-U-Cellular, another corporation that he and one or more of his sons, individually, would own. Petitioners have failed to establish that telephone company acquisition and cellular telephone diversification were reasonable business needs of NITCO during 1987 through 1989. Rule 142(a).

In conclusion, we find that NITCO's reasonable business needs, during 1987 through 1989, were as follows:

Business Need	1987	1988	1989
Working capital	$75,569	$278,646	$190,312
Retirement of long-term debt	557,505	170,760	–
Fiber optic to the exchange	300,000	100,000	100,000

Petitioners have failed to establish that NITCO, during these years, had reasonable business needs in excess of these amounts. Rule 142(a).

NITCO's Liability for Accumulated Earnings Tax

For 1987, 1988, and 1989, NITCO's accumulated earnings and adjusted net liquid assets exceeded the reasonable needs of the business. NITCO is therefore presumed to have accumulated its earnings with the purpose of avoiding income tax with respect to its shareholders. Sec. 533(a).

NITCO has failed to rebut this presumption of proscribed purpose. Sec. 533(a); *Technalysis Corp. v. Commissioner*, 101 T.C. at 403. Indeed, the record in the instant cases reflects the existence of factors that strongly indicate NITCO had this proscribed purpose. NITCO engaged in extensive nonbusiness-related activities to benefit and support Mr. Mussman's two sons. NITCO made investments that were unrelated to its business. From 1954 through 1994, NITCO never declared and paid a formal dividend to its shareholders. See sec. 1.533-1(a)(2), Income Tax Regs. We hold that NITCO, for 1987, 1988, and 1989, is liable for accumulated earnings tax.

II. NITCO's Deduction of Legal Expenses

On its 1987, 1988, and 1989 returns, NITCO claimed substantial business deductions for legal expenses. To be deductible by NITCO under section 162, NITCO must establish that these outlays were ordinary and necessary

expenses incurred in carrying on NITCO's trade or business. However, before, during, and after the years in issue, NITCO engaged in extensive nonbusiness-related activities to benefit and support Mr. Mussman's sons.

Whether a taxpayer is engaged in a trade or business is a question of fact. Although there are various factors that are important in making this determination, the most prominent of these factors are a profit motive and the carrying on of activities in a businesslike fashion. See *International Trading Co. v. Commissioner,* 275 F.2d 578, 584-85 (7th Cir. 1960), affg. T.C. Memo. 1958-104.

In *United States v. Gilmore,* 372 U.S. 39, 48 (1963), the Supreme Court held legal expenses to be deductible if the claim arises in connection with the taxpayer's profit-seeking activities. In the words of the Supreme Court in *Gilmore,* "the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was 'business' or 'personal' "; i.e., nonbusiness within the meaning of section 162(a). *Id.* at 49. In the instant cases, application of the *Gilmore* origin-of-the-claim test is crucial because NITCO, while a corporation, engaged in various activities, some of which were business activities and others of which were nonbusiness activities. See *Accardo v. Commissioner,* 942 F.2d 444, 449-451 (7th Cir. 1991), affg. 94 T.C. 96, 99-100 (1990)

Implicit in the *Gilmore* test is the further requirement that, for an expenditure to be deductible under section 162, it must be an ordinary and necessary expense, directly connected with or proximately resulting from the

taxpayer's business. *Kornhauser v. United States*, 276 U.S. 145, 153 (1928).

Petitioners contend that the disputed legal expenses NITCO incurred and paid, during the years in issue, are deductible ordinary and necessary business expenses under section 162. They argue that the litigation expenses with respect to the constitutional challenge, enforcement, and divestiture actions are deductible, because NITCO was a named party in the proceeding before the FCC, was the subject of the FCC's divestiture order, and was faced with the prospect of being fined or otherwise sanctioned by the FCC.

Respondent, on the other hand, contends that the disputed legal expenses are not deductible, because they fail to meet the *Gilmore* origin-of-the-claim test. Respondent maintains that the claims in the constitutional challenge, divestiture, and enforcement actions arose from nonbusiness activities that NITCO engaged in to benefit Mr. Mussman's son, Rhys, by assisting Rhys' cable television company NICATV. Respondent also asserts that petitioners have failed to establish that the disputed legal expenses were directly connected with or proximately resulted from NITCO's business activities. W. essentially agree with respondent.

We think that the mere naming of NITCO as a party in the FCC proceedings does not suffice to make the legal expenses deductible. *The Synanon Church v. Commissioner*, T.C. Memo. 1989-270.[16] In *Gilmore*, the Supreme Court noted:

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[16] But cf. *Kopp's Co. v. United States*, 636 F.2d 59, 61 (4th Cir. 1980), where the Court of Appeals for the Fourth Circuit

"Legal expenses do not become deductible merely because they are paid for services which relieve a taxpayer of liability. That argument would carry us too far. It would mean that the expense of defending almost any claim would be deductible by a taxpayer on the ground that such defense was made to help him keep clear of liens whatever income-producing property he might have. For example, it suggests that the

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distinguished *United States v. Gilmore*, 372 U.S. 39 (1963), reversed the lower court's holding that the legal expense in dispute failed to meet the origin-of-the-claim test, and allowed the taxpayer-corporation to deduct certain legal expense. In *Kopp's Co.*, the corporation incurred the legal expense in defending itself and a shareholder's son in a tort suit stemming from an accident involving a company car driven by the son. The son had not been a corporate employee, nor had he been engaged in performing corporate business. The court distinguished *Gilmore* on the basis that the taxpayer-corporation had been named as a party defendant and was alleged to have negligently permitted the son to operate its car. We think that *Kopp's Co. v. United States* is inapposite to the instant cases. Unlike the instant cases, the taxpayer-corporation in *Kopp's Co.* apparently engaged only in business activities. The activity giving rise to the lawsuit, although arguably unrelated to the taxpayer's business, was an isolated incident. In contrast, NITCO engaged in substantial nonbusiness activities before, during, and after the years in issue. Indeed, the precise activities giving rise to the proceedings in issue were NITCO's nonbusiness activities. For example, the FCC based its conclusion that NITCO and NICATV were affiliated, inter alia, upon the following nonbusiness activities: (1) NITCO's construction and maintenance of signal distribution facilities for NICATV, (2) Rhys' responsibility, while serving as NITCO's executive vice president, for negotiating pole attachment agreements with competing cable companies, (3) the fact that all contractual agreements between NITCO and NICATV were oral, and (4) Rhys' oral "consulting agreement".

> expense of defending an action based upon personal injuries caused by a taxpayer's negligence while driving an automobile for pleasure should be deductible. * * *
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> * * *
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> "It is not a ground for * * * [deduction] that the claim, if justified, will consume income-producing property of the defendant." * * * [*United States v. Gilmore*, 372 U.S. at 46-47 (quoting *Lykes v. United States*, 343 U.S. 118, 125-126 (1952)).]

Thus, the fact that NITCO may have been subject to being fined or otherwise sanctioned by the FCC is not controlling under the *Gilmore* origin-of-the-claim test, because those potential actions by the FCC concern only the attendant consequences of the litigation.

We have found that the activities that NITCO engaged in with respect to NICATV were not undertaken by NITCO with a profit motive. Indeed, NITCO's 1989 annual report to the IURC reflects that NITCO wrote off the approximately $122,000 "debt" that NICATV "owed" to NITCO. The purported debt was written off, despite the fact that Mr. Mussman knew that Rhys had realized sufficient cash from his sale of NICATV to discharge the "debt." In addition, in its 1989 annual report to the IURC, NITCO stated that the writeoff was not deductible for tax purposes.[17] We conclude that the activities that NITCO

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[17] At trial, Mr. Mussman claimed that the writeoff occurred due to an inadvertent error on the part of NITCO's accountant. He related that the accountant, unlike Mr. Mussman, did not know that Rhys had realized sufficient cash from the sale of NICATV to discharge the "debt". We find Mr. Mussman's tale of

engaged in with respect to NICATV were nonbusiness activities of NITCO. See *International Trading Co. v. Commissioner*, 275 F.2d at 584-585. As the claim in the divestiture and enforcement actions arose in connection with these nonbusiness activities that NITCO engaged in with respect to NICATV, the legal expenses of the divestiture and enforcement actions are not deductible by NITCO under section 162. See *United States v. Gilmore, supra; Accardo v. Commissioner, supra; Dower v. United States*, 668 F.2d 264, 266 (7th Cir. 1981); *Anchor Coupling Co. v. United States*, 427 F.2d 429, 431-433 (7th Cir. 1970). Petitioners have further failed to establish that the constitutional challenge action arose in connection with or proximately resulted from a business activity of NITCO.[18] The legal

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mere inadvertence to be incredible and not worthy of belief. We doubt that the accountant would write off as uncollectible this large $122,000 "receivable", without consulting Mr. Mussman and NITCO's other top management. Moreover, even if the "receivable" were inadvertently written off on NITCO's books, this still does not adequately explain why NITCO never took action to collect the "debt", as Mr. Mussman knew that Rhys possessed sufficient cash to discharge the "debt". Additionally, we are not convinced that Mr. Mussman was unaware of the accountant's "error". In signing NITCO's 1989 annual report to the IURC, Mr. Mussman represented that the information contained in the report, to the best of his knowledge, was true and correct under penalty of perjury. We think that Mr. Mussman all along never intended that NITCO actually be paid by NICATV and Rhys for much of the work and other assistance that NITCO provided to NICATV.

[18] From petitioners' briefs, we gather that they are not contending that the claim in the constitutional challenge action arose in connection with Rhys' alleged desire to purchase shares of NITCO's stock from Mr. Mussman. As we understand their contentions, the constitutional challenge action was brought by

expenses incurred in the constitutional challenge action are thus not deductible by NITCO under section 162. *United States v. Gilmore, supra; Kornhauser v. United States, supra.*

Similarly, petitioners have failed to establish that the RSA #1, Dial One Mobile, Dial One USA, Sprint contract, and Postal Service investigation matters arose in connection with or proximately resulted from a business activity of NITCO. With respect to the RSA #1 venture, Mr. Mussman's intention and plan was to have the cellular license rights that were obtained transferred to Serv-U-Cellular, a corporation that he and one or more of his sons, individually, would own. Much of this plan was then implemented with Serv-U-Cellular, rather than NITCO, becoming a partner in the RSA #1 limited partnership. NITCO reported on its return substantially all the $750,000 paid to Serv-U-Cellular only after Mr. Mussman was forced to abandon the plan as a result of the examinations that resulted in respondent's issuances of the notices of deficiency in the instant cases. With respect to the Dial One Mobile matters, Dial One Mobile was a company owned by Rhys that was conducting activities with respect to cellular telephone systems in Asheville, North Carolina, and Enid, Oklahoma. NITCO had no interest in Dial One Mobile. According to the application that Dial One USA filed with the IURC to sell long-distance services, NITCO had no interest in Dial One USA. The Postal Service investigation matter involved a

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Rhys and NITCO in order to challenge the constitutionality of the FCC's cross-ownership rules, as the constitutional issues could not be litigated in the divestiture action.

seizure of NICATV's records from NICATV's business offices. Accordingly, the legal expenses that NITCO incurred in the RSA #1, Dial One Mobile, Dial One USA, Sprint contract, and Postal Service investigation matters are not deductible under section 162. *United States v. Gilmore, supra; Kornhauser v. United States, supra.*

Finally, petitioners have failed to establish that the legal expenses incurred in certain other unknown matters or proceedings arose in connection with or were proximately related to a business activity of NITCO. Therefore, the legal expense that NITCO incurred in these unknown matters or proceedings are not deductible under section 162. *United States v. Gilmore, supra; Kornhauser v. United States, supra.*

In conclusion, with respect to the legal expenses for which NITCO claimed 1987, 1988, and 1989 business deductions, we hold that only those legal expenses that respondent has conceded are deductible by NITCO under section 162.

III. Constructive Dividend Income

In the notice of deficiency issued to Mr. and Mrs. Mussman, respondent determined that certain payments made by NITCO represented constructive dividend income to Mr. Mussman for 1988 and 1989. It is well established that a payment made to a shareholder's family member can constitute a section 301 distribution by a corporation with respect to the stock of the shareholder. *Green v. United States,* 460 F.2d 412, 419 (5th Cir. 1972); *Epstein v. Commissioner,* 53 T.C. 459, 474-475 (1969). Under proper circumstances, it is appropriate to hold that a

corporate payment made to or on behalf of a shareholder's family member represents a distribution by the corporation to the shareholder, because the shareholder enjoys the use of the property as much as if the corporation had distributed the property directly to the shareholder. *Epstein v. Commissioner, supra.* In determining whether an expenditure by a corporation represents income to the shareholder, it is necessary to decide whether the expenditure primarily benefited the shareholder personally rather than furthered the interest of the corporation. *Hagaman v. Commissioner,* 958 F.2d 684, 690-691 (6th Cir. 1992) affg. on this issue T.C. Memo. 1987-549; *Ireland v. United States,* 621 F.2d 731, 735 (5th Cir. 1980).

Legal Expenses for which Respondent Disallowed Business Deductions to NITCO

In the notice of deficiency issued to the Mussmans, respondent determined that the legal expenses for which respondent disallowed business deductions to NITCO for 1988 and 1989 represented constructive dividend income to Mr. Mussman. Respondent further determined that these legal expenses were unrelated to NITCO's business.

We previously have held that substantially all these legal expenses were not deductible under section 162 by NITCO, because petitioners failed to establish the expenses were deductible under the *Gilmore* origin-of-the-claim test. Most of these legal expenses were incurred in the constitutional challenge, divestiture, and enforcement actions discussed *supra.*

To the extent a substantive difference exists between the *Gilmore* origin-of-the-claim test discussed at pages 67-68, *supra*, and the analysis for whether a particular payment should be treated as constructive dividend income, petitioners in the instant cases have failed to meet their burden in proving that NITCO's payment of the legal expenses: (1) Did not primarily benefit Mr. Mussman's son Rhys, (2) furthered the interest of NITCO, and (3) was of direct and substantial economic benefit to NITCO. Compare *Hagaman v. Commissioner, supra*, and *Ireland v. Untied States, supra*, with *Parker v. Commissioner*, 365 F.2d 792, 801-802 (8th Cir. 1966), affg. in part, revg. in part, and remanding T.C. Memo. 1965-77.[19]

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[19] In *Parker v. Commissioner*, 365 F.2d 792, 801-802 (8th Cir. 1966), affg. in part, revg. in part, and remanding *Foundation for Divine Mediation, Inc. v. Commissioner*, T.C. Memo. 1965-77, the founder and head of a religious organization was prosecuted for contributing to the delinquency of a minor. Following his acquittal, he brought an action for slander. The religious organization paid the expenses of both the criminal and civil actions. This Court viewed the legal expenses as a personal expense of the founder and held that their payment by the organization represented taxable income to the founder. In reversing, the Court of Appeals for the Eighth Circuit stated that because the reputation and business of the organization were inextricably bound up with its founder, the payment of the expenses was of direct and substantial benefit to the organization. Although the Court of Appeals for the Eighth Circuit further stated, in dicta, that the expenses would be deductible by the organization as an ordinary and necessary business expense, the issue of the expenses' deductibility had not been raised. Thus, the Court of Appeals for the Eighth Circuit did not have the deductibility issue before it and did not address the *Gilmore* origin-of-the-claim test.

With respect to the legal expenditures for the constitutional challenge, divestiture, and enforcement actions, petitioners contend the expenditures directly benefited NITCO, because they prevented NITCO from being subjected to a fine and protected its business reputation with the FCC.

We consider the hundreds of thousands of dollars in legal expenditures that NITCO incurred in litigating the constitutional challenge, divestiture, and enforcement actions, to have been of dubious benefit to NITCO and its business, particularly since, as indicated above, the activities that NITCO engaged in with respect to NICATV were not undertaken by NITCO with a profit motive. We are thus not convinced that the litigation of the constitutional challenge, divestiture, and enforcement actions furthered NITCO's interest and was of direct and substantial benefit to NITCO. Rather, the litigation primarily benefited Rhys, by giving Rhys' company NICATV the further time it needed to build up its cable television system business.

Moreover, we perceive the protracted litigation to have been actually more harmful to NITCO's good reputation with the FCC, rather than helpful. In view of NICATV's and NITCO's refusal to comply with the FCC's orders in the divestiture action, the FCC referred the matter to the Department of Justice for appropriate enforcement proceedings. Ultimately, in July 1989, Rhys sold NICATV.

With respect to the legal expenses for which we sustained respondent's disallowance of business deductions by NITCO for 1988 and 1989, we sustain

respondent's determination that NITCO's payment of those legal expenses represented constructive dividend income to Mr. Mussman for 1988 and 1989. Petitioner have failed to establish that NITCO's payment of the expenses did not primarily benefit the Mussman family, furthered NITCO's interest, and was of direct and substantial benefit to NITCO. Rule 142(a).

Amount NITCO Paid to Rhys on December 20, 1988

In the notice of deficiency issued to the Mussmans, respondent determined that $22,646, which NITCO paid to Rhys on December 20, 1988, was constructive dividend income to Mr. Mussman. On brief, petitioners have advanced only a vague argument that Rhys served as a "consultant" to NITCO in 1985 and in 1989.

Petitioners have failed to establish that the payment furthered NITCO's interest and was of direct and substantial benefit to NITCO. They have not offered any details or specific information concerning what, if any, actual "consulting work" Rhys performed for NITCO. Indeed, in NITCO and Rhys' March 24, 1988, complaint in the constitutional challenge action, they alleged that Rhys received no compensation from NITCO and had no formal responsibilities at NITCO. We hold that the $22,646 payment was constructive dividend income to Mr. Mussman in 1988. Rule 142(a).

"Open Account Loans"

NITCO on its books recorded certain payments that it had made as "open loan account payments" to Mr. Mussman. In the notice of deficiency issued to the Mussmans, respondent determined that $13,814 in "open account loans" that NITCO made for 1988 and $16,792 in "open account loans" that NITCO made for 1989, represented constructive dividend income to Mr. Mussman. Respondent has now conceded that certain of the 1988 and 1989 payments NITCO made were not constructive dividend income to Mr. Mussman. Petitioners, on the other hand, have conceded that certain other of the 1988 and 1989 payments NITCO made were constructive dividend income to Mr. Mussman. Still at issue between the parties is whether the remaining $7,058.11 of 1988 "open account loans" and the remaining $3,263.51 of 1989 "open account loans" were constructive dividend income to Mr. Mussman.

Of the remaining $7,058.11 in disputed 1988 payments, the parties agree that at least $6,119.95 of the payments was for utility bills with respect to the 301 North Washington Street property that NITCO was subleasing to NICATV, Rhys's cable television company. The parties cannot agree on the identification of the balance of the disputed 1988 payments. Similarly, of the remaining $3,263.51 of disputed 1989 payments, the parties agree that the entire $3,263.51 was paid by NITCO for utility bills with respect to the 301 North Washington Street property that NITCO was subleasing to NICATV. All the 1989 utility bill expenses covered the period from January 1 through June 30, 1989, when NICATV occupied the 301 North Washington Street building.

We have previously determined that NITCO's activities with respect to NICATV were not undertaken by NITCO with a profit motive. Petitioners, however, contend that NITCO's payments of the utility bills directly benefited NITCO, because NITCO also stored certain telephone equipment in the 301 North Washington Street building.

Mr. Mussman testified that NITCO paid these utility bills because it had stored some of its telephone equipment in the 301 North Washington Street building that it was subleasing to NICATV. The revenue agent, however, testified that, during his visit to the building during the fall of 1992, he found only a few pieces of office furniture stored there. On brief, petitioners have tried to explain this conflict by claiming the agent was only able to observe the space in the building to which he was given access. More importantly, however, petitioners have failed to adequately explain why the utility bill payments were recorded as "open account loans" to Mr. Mussman if the payments were, in fact, business expenses of NITCO.

We conclude that petitioners have failed to establish that these 1988 and 1989 utility bill payments with respect to the 301 Washington Street property furthered NITCO's interest and were of direct and substantial benefit to NITCO. The payments primarily benefited Rhys and NICATV. On the record presented, we also are not able to determine the extent of the storage use NITCO made of the building. We decline to speculate and allocate a portion of the utility bill payments to a business use of

NITCO.[20] Petitioners have further failed to establish that the remaining balance of the disputed 1988 "open account loans" furthered NITCO's interest and directly and substantially benefited NITCO. We hold that Mr. Mussman had constructive dividend income of $7,058.11 for 1988 and $3,263.51 for 1989, as a result of the "open account loans".[21]

Country Club Initiation Fee

In early 1989, NITCO paid an $1,800 initiation fee on behalf of Rhys to obtain a country club membership for Rhys. Petitioners have acknowledged that Rhys was not a NITCO employee until after July 1, 1989. However, they argue that the club membership was purchased in anticipation of Rhys' returning to NITCO's employ, because a waiting list existed at the country club for memberships. They assert that, following his resumption of employment with NITCO, the membership would be used by Rhys in connection with NITCO's business activities.

In view of the substantial expenditures NITCO made for NICATV's and Rhys' benefit that we have held to be constructive dividend income to Mr. Mussman, we are

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[20] The utility bill payments were for electricity, gas, sewage, and water services provided to the 301 Washington Street property. To the extent that NITCO made some incidental use of the building for storage, it is difficult to quantify the actual benefit that resulted to NITCO from the payments.

[21] From petitioners' arguments in their posttrial briefs concerning this issue, we gather that petitioners are not contending that NITCO had made a bona fide loan to Mr. Mussman with respect to these payments.

extremely skeptical of petitioners' claims with respect to NITCO's payment of the club initiation fee for Rhys. Petitioners have failed to establish that the expenditure was a business expenditure of NITCO, rather than constructive dividend income to Mr. Mussman. Consequently, we sustain respondent's determination that the $1,800 expenditure to obtain a country club membership for Rhys was constructive dividend income to Mr. Mussman. Rule 142(a).

Cellular Telephone and Other Investments

In the notice of deficiency issued to the Mussmans, respondent determined that $88,484 of legal expenditures that NITCO made with respect to certain "cellular telephone and other investments" was constructive dividend income to Mr. Mussman in 1989. NITCO claimed no deduction for these expenditures.

Petitioners contend that a substantial portion of the $88,484 in total expenditures was actually paid by NITCO in 1988, rather than in 1989, and that these 1988 payments were erroneously determined by respondent to be constructive dividend income to Mr. Mussman in 1989. They point out that in the notice of deficiency issued to the Mussmans, respondent failed to treat any portion of the $88,484 payments as dividend income to Mr. Mussman in 1988. They assert that the $75,432 of cellular telephone investment account expenditures NITCO recorded includes $33,445.68 in payments made by NITCO in 1988. Similarly, they assert that the $13,052 of other investment account expenditures NITCO recorded includes $9,562.42 in payments NITCO made in 1988. Respondent, on the

other hand, disputes that any of the $88,484 in expenditures was made by NITCO during 1988.

The record does not support petitioners' claim that the $88,484 in expenditures includes cellular telephone expenditures that were made by NITCO during 1988, rather than during 1989. In the Schedule B-8 to the 1989 annual report it filed with the IURC, NITCO reported that it had $75,342 of "deferred cellular charges" and $13,052 of deferred "other" charges. Yet, in the Schedule B-8 to the 1988 annual report it filed with the IURC, NITCO reported that it had $390,000 of "extraordinary retirements" and $39,599 of deferred "other" charges. The Schedule B-8 to the 1988 report reflected no "deferred cellular charges" for 1988. We conclude that petitioners have failed to establish that $88,484 in expenditures includes payments that were made by NITCO in 1988.

At pages 39-40, *supra*, of our findings, we have attempted to allocate and attribute the $88,484 of expenditures to specific matters as best as we can on the record presented. We essentially have attributed the $88,484 only to those specific matters the parties agree upon.

With respect to the $1,166.59 NITCO expended to Andrew & Kurth for Dial One Mobile, petitioners have conceded that the payment was constructive dividend income to Mr. Mussman in 1989, and we so hold. NITCO also expended $32,363.64 to B&H for Dial One Mobile work. Dial One Mobile was a company Rhys owned, which was conducting activities with respect to cellular telephone systems in Asheville, North Carolina, and Enid, Oklahoma. NITCO had no interest in Dial One Mobile. Petitioners have failed to show that the payment

was of direct and substantial benefit to NITCO. We hold that the $32,363.64 in payments made to B&H was constructive dividend income to Mr. Mussman for 1989.

With respect to the $3,327.50 NITCO expended to EMCI for cellular telephone publications, it is not clear whether the cellular telephone publications were purchased and used to benefit NITCO, as opposed to individual members of the Mussman family. Petitioners have failed to establish that the expenditure furthered NITCO's interest and was of direct and substantial benefit to NITCO. We hold that the $3,327.50 payment was constructive dividend income to Mr. Mussman in 1989. Rule 142(a).

With respect to the expenditures NITCO made to Handlon & Handlon for various matters, petitioners concede that a $264 payment was for work performed for Kyle's corporation, FiberComm, and that such payment was constructive dividend income to Mr. Mussman for 1989. As to the remaining balance of the expenditures NITCO made to Handlon & Handlon, petitioners have failed to establish that these payments furthered NITCO's interest and were of direct and substantial benefit to NITCO.

NITCO paid Handlon & Handlon $1,525.81 for work with respect to Dial One USA and Intelcom, which were corporations that Mr. Mussman owned. According to the 1988 application that Dial One USA filed with the IURC in seeking authorization to sell long-distance services, NITCO had no affiliation with Dial One USA and Intelcom. Although Mr. Mussman, at trial, claimed that he later planned to have Intelcom become the parent holding

company of Dial One USA and NITCO, we do not find his self-serving testimony credible, as this testimony is inconsistent with the statements made on Dial One USA's application to the IURC.

NITCO also paid Handlon & Handlon $234 for the incorporation of Northwestern Indiana Cellular, a corporation formed to hold various cellular telephone interests. On the record presented, it is not clear whether Mr. Mussman intended that Northwestern Indiana Cellular be owned by NITCO or by individual members of the Mussman family. It is also not clear whether the cellular telephone interests Mr. Mussman planned to have held by Northwestern Indiana Cellular would be cellular telephone interests that NITCO or individual members of the Mussman family owned.

We hold that the entire $2,120.81 in the above payments that NITCO made to Handlon & Handlon, including the $229 expended for an unknown matter, was constructive dividend income to Mr. Mussman for 1989.

With respect to the expenditures NITCO made to LMN&G, petitioners concede that $4,400 was constructive dividend income to Mr. Mussman in 1989. As to the work LMN&G performed in connection with the Indiana RSA #1 venture and for Rhys, petitioners have failed to establish that NITCO's payment for the work furthered NITCO's interest and was of direct and substantial benefit to NITCO. As we have found, Mr. Mussman intended and planned to have the cellular telephone rights held by Serv-U-Cellular, a corporation that he and one or more of his sons, individually, would own. Rhys was not an employee of NITCO until after July 1, 1989, and the work

LMN&G performed for Rhys was billed before that date. Consequently, we hold that all the expenditures that NITCO made to LMN&G were constructive dividend income to Mr. Mussman for 1989. Rule 142(a).

With respect to the balance of NITCO's expenditures that has not been attributed to specific matters, petitioners have failed to establish that these payments furthered NITCO's interest and were of direct and substantial benefit to NITCO. Consequently, we hold that these payments were constructive dividend income to Mr. Mussman for 1989.[22] Rule 142(a).

IV. Additions to Tax

Sections 6653(a) and 6662 Additions For Negligence Or Intentional Disregard of Rules and Regulations

In the notice of deficiency issued to NITCO, respondent determined that NITCO was liable for additions to tax for negligence or intentional disregard of rules or regulations (1) under section 6653(a), equal to 5 percent of the respective underpayments for 1987 and 1988, and (2) under section 6662, equal to 20 percent of a portion of the underpayment for 1989. Respondent determined that the 20-percent addition under section 6662 should apply with respect to a $117,547 portion of the underpayment for 1989. Respondent further determined that NITCO was liable for an addition to tax under section 6653(a)(1)(B) for 1987. Under section 6653(a)(1)(B), an addition to tax

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[22] These constructive dividends to Mr. Mussman, of course, will increase NITCO's dividend paid deduction in computing NITCO's accumulated earning tax liability. See sec. 535(a).

(equal to 50 percent of the interest payable under section 6601) is imposed with respect to the portion of the underpayment attributable to negligence. Respondent determined that the portion of the 1987 underpayment resulting from NITCO's improper deduction of $467,673 in legal expenses was attributable to negligence on NITCO's part.

In the notice of deficiency issued to the Mussmans, respondent determined the Mussmans were liable for additions to tax for negligence or intentional disregard of rules or regulations (1) under section 6653(a), equal to 5 percent of the underpayment for 1988, and (2) under section 6662, equal to 20 percent of the underpayment of 1989. Respondent determined that the 20-percent addition under section 6662 should apply with respect to the entire underpayment for 1989.

Negligence has been defined as the failure to exercise the due care that a reasonable and ordinarily prudent person would do under the circumstances. *Neely v. Commissioner*, 85 T.C. 934, 947 (1985). Petitioners bear the burden of showing that they are not negligent. Rule 142(a); *Bixby v. Commissioner*, 58 T.C. 757, 791-792 (1972).

Petitioners argue that NITCO and the Mussmans are not liable for additions to tax for negligence. Their contentions are as follows:

> Respondent has not rebutted any of the facts supporting the reasonableness of NITCO's accumulations. Imposition of the * * * [accumulated earnings tax] and any additional penalty is therefore unwarranted. Similarly, imposing penalties for deducting the allegedly nondeductible attorneys' fees and other costs

> attributable to billing errors by outside attorneys or oversight by the independent accountant would also be improper. None of any underpayment ultimately determined is attributable to negligence or intentional disregard. * * *

We have previously held that NITCO is liable for accumulated earnings tax for 1987, 1988, and 1989, because NITCO accumulated its earnings beyond the reasonable needs of the business and was availed of for the purpose of avoiding income tax with respect to its shareholders. We further held that, for 1987, 1988, and 1989, substantial business deductions for legal expenses that NITCO claimed were not allowable to NITCO under section 162, because the expenditures failed to meet the *Gilmore* origin-of-the-claim test. We also held that Mr. Mussman had large amounts of constructive dividend income for 1988 and 1989, including the 1988 and 1989 legal expenses NITCO had paid in litigating the constitutional challenge, divestiture, and enforcement actions.

Petitioners have failed to establish: (1) NITCO acted reasonably in claiming deductions for these legal expenses; and (2) the Mussmans acted reasonably in not reporting NITCO's payments of the 1988 and 1989 legal expenses as constructive dividend income to Mr. Mussman. Petitioners imply that the attorneys' fees in the constitutional challenge, divestiture, and enforcement actions were deducted because the outside law firms had billed their work to NITCO, rather than to Rhys and NICATV. We are not convinced that NITCO acted reasonably in deducting the fees it paid merely because the work had been billed to NITCO. Indeed, in one instance NITCO still claimed a 1989 deduction with respect to its

payment of $2,239.85 to W&C for certain Dial One Mobile work, even though W&C billed the legal work to Rhys and not to NITCO. Petitioners have not conceded that the $2,239.85 payment is not deductible by NITCO and was constructive dividend income to Mr. Mussman.

With respect to the purported advice petitioners received from the accountant, we are not satisfied that the accountant was apprised of all the relevant facts, including the fact that the activities NITCO engaged in with respect to NICATV were not undertaken by NITCO with a profit motive. See *Collins v. Commissioner*, 857 F.2d 1383, 1386 (9th Cir. 1988), affg. *Dister v. Commissioner*, T.C. Memo. 1987-217. The record fails to disclose what specifically the accountant was told or was not told by NITCO and Mr. Mussman.

Although reliance on the advice of qualified professional advisers may defeat a finding of negligence under certain circumstances, petitioners have not established that the reliance in the instant cases was reasonable. *Freytag v. Commissioner*, 89 T.C. 849, 888 (1987), affd. 904 F.2d 1011 (5th Cir. 1990), affd. 501 U.S. 868 (1991).

Petitioners generally have failed to carry their burden in establishing that all or parts of their respective underpayments were not attributable to negligence. Rule 142(a).

We hold that NITCO is liable for additions to tax for negligence (1) under section 6653(a)(1)(A) and (B), for 1987 and 1988, and (2) under section 6662 for 1989. The section 6662 addition applies with respect to that part of the $117,547 portion of the underpayment for 1989 that respondent determined to be attributable to negligence or

intentional disregard of rules or regulations, which we have sustained. We further hold that NITCO will be liable for an addition to tax under section 6653(a)(1)(B) for 1987 with respect to the portion of the underpayment for 1987 attributable to NITCO's improper deduction of certain legal expenses.

Similarly, we hold that the Mussmans are liable for additions to tax for negligence (1) under section 6653(a) for 1988 and (2) under section 6662 for 1989. The section 6662 addition applies with respect to the entire underpayment for 1989.

Section 6661 Additions for Substantial Understatement

In the notice of deficiency issued to NITCO, respondent determined that NITCO was liable for additions to tax for substantial understatement of income tax liability under section 6661 for 1987 and 1988. In the notice of deficiency issued to the Mussmans, respondent determined the Mussmans were liable for an addition to tax for substantial understatement under section 6661 for 1988.

Section 6661 provides for an addition to tax for substantial understatement of income tax equal to 25 percent of the amount of the underpayment attributable to such understatement for the taxable year. To be considered substantial, the understatement must exceed the greater of $5,000 ($10,000 in the case of a corporation like NITCO) or 10 percent of the tax required to be shown on the return. Sec. 6661(b)(1). The amount of the understatement is reduced by the portion of the understatement attributable to any nontax shelter item for which there is

either substantial authority for the taxpayer's return position or adequate disclosure on the return. Sec. 6661(b)(2)(B).

NITCO understated its tax for 1987 and 1988; the Mussmans understated their tax for 1988. These respective understatements were substantial. Petitioners have not asserted that the understatements should be reduced under section 6661(b)(2)(B) or that respondent should have waived all or any part of the additions to tax under section 6661(c).[23] We hold that NITCO is liable for additions to tax under section 6661 for 1987 and 1988 and that the Mussmans are liable for an additional tax under section 6661 for 1988.

Section 6621(c) Increased Interest for Large Corporate Underpayments

In the notice of deficiency issued to NITCO, respondent determined that, for 1987 and 1988, NITCO was liable for increased interest under section 6621(c) for large corporate underpayments and that the section

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[23] On brief, petitioners make the vague argument that they should not be held liable for the sec. 6661 additions to tax, because "the substantial understatement penalty is computational, and thus may not apply; if it does, the penalty is inappropriate because reasonable cause can be found for the understatement." However, "reasonable cause", standing alone, is not a sufficient basis for avoiding liability with respect to the sec. 6661 addition. See H. Conf. Rept. 97-760 at 575 (1982), 1982-2 C.B. 600, 650. At any rate, petitioners have failed to establish: (1) There was substantial authority for their return positions or reasonable disclosure on their returns; or (2) respondent should have waived all or part of the additions. Rule 142(a).

6621(c) increase should apply with respect to NITCO's entire underpayments for 1987 and 1988.

Section 6621(c) provides a higher interest rate for purposes of computing the interest payable (under section 6601) on any "large corporate underpayment".[24] A large corporate underpayment is defined to include any underpayment of income tax by a C corporation for any taxable year if the amount of the underpayment exceeds $100,000. Sec. 6621(c)(3). The increased interest rate applies for purposes of computing the statutory interest payable for periods after the "applicable date". Sec. 6621(c)(1). Where the deficiency procedures apply, as in the instant cases, the "applicable date" generally is the 30th day after the earlier of: (1) The date the corporate taxpayer is issued a so-called "30-day letter" by the IRS, or (2) the date on which the corporate taxpayer is issued the notice of deficiency. Sec. 6621(c)(2)(A); Sec. 301.6621(3)(c)(2), Proced. & Admin. Regs.

Assuming the $100,000 section 6621(c)(3) threshold amount is met, we hold that NITCO, for 1987 and 1988, is liable for increased interest under section 6621(c) for substantial corporate underpayments, and that the section 6621(c) increases apply with respect to the entire underpayments for 1987 and 1988.

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[24] Sec. 6621(c) applies and is effective for purposes of determining such interest for periods after Dec. 31, 1990, regardless of the fact that the taxable period to which the underlying tax relates is before Dec. 31, 1990. Omnibus Budget Reconciliation Act of 1990, sec. 11341(a), Pub. L. 101-508, 104 Stat. 1388, 1388-470-471; sec. 301.6621-3(e), Proced. & Admin. Regs.

To reflect the foregoing and certain adjustments agreed to by the parties,

Decisions will be entered under Rule 155.

UNITED STATES TAX COURT

WASHINGTON, DC 20217

NORTHWESTERN INDIANA TELEPHONE COMPANY Petitioner, v. COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	Docket No. 7970-91

ORDER

For cause, it is

ORDERED: That the opinion of the Court, which was filed herein on April 2, 1996 (T.C. Memo. 1996-168), be and the same is modified by eliminating all references to section 6621(c), I.R.C., by substituting new pages 2 and 91 in lieu of pages 2 and 91-93. It is further

ORDERED: That the opinion of this Court in all other respects remains unchanged.

/s/ Robert P. Ruwe
Robert P. Ruwe
Judge

Dated: Washington, D.C.
April 17, 1996

[p. 2] 1. *Held:* NITCO is liable for accumulated earnings tax because its accumulated earnings exceeded its reasonable business needs and NITCO was availed of to avoid income tax with respect to its shareholders.

2. *Held, further,* most of the legal expenses in issue are not deductible under sec. 162, I.R.C.

3. *Held, further,* M had constructive dividend income.

4. *Held, further,* NITCO is liable for the additions to tax.

5. *Held, further,* M and M's wife are liable for the additions to tax.

David J. Duez, Gail H. Morse, and *Roger W. Wenthe,* for petitioners.

Marjory A. Gilbert, Linda Grobe, and *Claire McKenzie,* for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

RUWE, *Judge*: Respondent determined deficiencies in petitioners' Federal income taxes and additions to tax as follows:

Northwestern Indiana Telephone Co.
docket No. 7970-91

		Additions to Tax			
Year	Deficiency	Sec. 6653(a)(1)(A)	Sec. 6653(a)(1)(B)	Sec. 6661	Sec. 6662
1987	$786,115.00	$39,305.75	[1]	$182,675.75	–
1988	429,006.00	21,450.30	–	101,935.50	–
1989	329,369.00	–	–	–	$23,509.40

[1] 50 percent of the interest due on $55,412.

* * *

[p. 91] that respondent should have waived all or any part of the additions to tax under section 6661(c).[23] We hold that NITCO is liable for additions to tax under section 6661 for 1987 and 1988 and that the Mussmans are liable for an addition to tax under section 6661 for 1988.

Decisions will be entered under Rule 155.

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[23] On brief, petitioners make the vague argument that they should not be held liable for the sec. 6661 additions to tax, because "the substantial understatement penalty is computational, and thus may not apply; if it does, the penalty is inappropriate because reasonable cause can be found for the understatement." However, "reasonable cause", standing alone, is not a sufficient basis for avoiding liability with respect to the sec. 6661 addition. See H. Conf. Rept. 97-760 at 575 (1982), 1982-2 C.B. 600, 650. At any rate, petitioners have failed to establish: (1) There was substantial authority for their return positions or reasonable disclosure on their returns; or (2) respondent should have waived all or part of the additions. Rule 142(a).

UNITED STATES TAX COURT

NORTHWESTERN INDIANA TELEPHONE COMPANY,	)	Docket No. 7970-91
Petitioner,	)	
v.	)	
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent.	)	

DECISION

Pursuant to the opinion of the Court filed April 2, 1996, as modified on April 17, 1996, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED:

That there are deficiencies in income tax due from the petitioner for the taxable years 1987, 1988 and 1989 in the amounts of $582,775, $330,892 and $204,040, of which $372,918, $240,589 and $73,628, respectively, are attributable to the imposition of tax on accumulated earnings under the provisions of I.R.C. § 531;

That there is a penalty due from the petitioner for the taxable year 1987, under the provisions of I.R.C. § 6653(a)(1)(A), in the amount of $29,139;

That there is a penalty due from the petitioner for the taxable year 1987, under the provisions of I.R.C. § 6653(a)(1)(B), in an amount equal to 50 percent of the statutory interest due on $151,677;

That there is a penalty due from the petitioner for the taxable year 1988, under the provisions of I.R.C. § 6653(a), in the amount of $16,545;

That there are penalties due from the petitioner for the taxable years 1987 and 1988, under the provisions of I.R.C. § 6661, in the amounts of $37,919 and $17,170, respectively; and

That there is a penalty due from the petitioner for the taxable year 1989, under the provisions of I.R.C. § 6662(a), in the amount of $22,983.

(Signed) Robert P. Ruwe
Judge.

Entered: NOV 13 1996

* * *

The parties stipulate that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

It is further stipulated that interest will be assessed as provided by law on the deficiencies and penalties due from the petitioner.

It is further stipulated that the respondent claims an increased penalty, under the provisions of I.R.C. § 6653(a)(1)(B), for the taxable year 1987 in an amount equal to the excess of 50% of the interest due on $151,677

of the deficiency over 50% of the interest due on $55,412, pursuant to the provisions of I.R.C. § 6214(a).

It is further stipulated that the deficiency of the taxable year 1987 is computed without considering the payments of $136,630 and $1,285,289 made on April 28, 1995 and April 24, 1996, respectively, which will be applied to tax, additions to tax and interest as provided by law.

It is further stipulated that the deficiency for the taxable year 1988 is computed without considering the payments of $55,313 and $694,181 made on April 28, 1995 and April 24, 1996, respectively, which will be applied to tax, additions to tax and interest as provided by law.

It is further stipulated that the deficiency for the taxable year 1989 is computed without considering the payments of $36,552 and $353,784 made on April 28, 1995 and April 24, 1996, respectively, which will be applied to tax, additions to tax and interest as provided by law.

STUART L. BROWN
Chief Counsel
Internal Revenue Service

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/s/ Robert G. Mussman
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Assistant District Counsel
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Date: 11/4/96 Date: NOV 05 1996

UNITED STATES TAX COURT

ROBERT G. MUSSMAN and ESTATE OF MYRTIS MUSSMAN, DECEASED ROBERT G. MUSSMAN, EXECUTOR,	)	Docket No. 7971-91
Petitioners,	)	
v.	)	
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent.	)	

DECISION

Pursuant to the opinion of the Court filed April 2, 1996, as modified on April 17, 1996, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED: That there are deficiencies in income tax due from the petitioners for the taxable years 1988 and 1989 in the amounts of $72,559 and $121,257 respectively;

That there is a penalty due from the petitioners for the taxable year 1988, under the provisions of I.R.C. § 6653(a)(1), in the amount of $3,628;

That there is a penalty due from the petitioners for the taxable year 1988, under the provisions of I.R.C. § 6661, in the amount of $18,140; and

That there is a penalty due from the petitioners for the taxable year 1989, under the provisions of I.R.C. § 6662(a), in the amount of $24,251.

(Signed) Robert P. Ruwe
Judge.

Entered: Nov. 13, 1996

* * *

Docket No. 7971-91

The parties stipulate that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

It is further stipulated that interest will be assessed as provided by law on the deficiencies and penalties due from the petitioner.

It is further stipulated that the deficiency for the taxable year 1988 is computed without considering the payments of $3,984 and $148,865 made on April 28, 1995 and April 24, 1996, respectively, which will be applied to tax, additions to tax and interest as provided by law.

It is further stipulated that the deficiency for the taxable year 1989 is computed without considering the payments of $32,822 and $189,021 made on April 28, 1995 and April 24, 1996, respectively, which will be applied to tax, additions to tax and interest as provided by law.

STUART L. BROWN
Chief Counsel
Internal Revenue Service

By: /s/ Marjory A. Gilbert
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/s/ Robert G. Mussman
ROBERT G. MUSSMAN
Petitioner

/s/ Robert G. Mussman
ESTATE OF MYRTIS MUSSMAN,
DECEASED, ROBERT G.
MUSSMAN, EXECUTOR
Petitioner
325 Jefferson Street
Hebron, Indiana 46341

Date: 11/4/96

Date: Nov. 05, 1996

United States Court of Appeals

For the Seventh Circuit
Chicago, Illinois 60604

January 7, 1998

Before

Hon. Walter J. Cummings, *Circuit Judge*
Hon. John L. Coffey, *Circuit Judge*
Hon. Terence T. Evans, *Circuit Judge*

NORTHWESTERN INDIANA TELEPHONE COMPANY, *Petitioner-Appellant,* No. 97-1021 v. COMMISSIONER OF INTERNAL REVENUE, *Respondent-Appellee.*	)	Appeal from Decisions of the United States Tax Court. Nos. 7970-91 and 7971-91
ROBERT G. MUSSMAN and ESTATE OF MYRTIS MUSSMAN, Deceased, ROBERT G. MUSSMAN, Executor, *Petitioner-Appellant,* No. 97-1056 v. COMMISSIONER OF INTERNAL REVENUE, *Respondent-Appellee.*	)	

ORDER

On December 5, 1997, petitioners-appellants filed a petition for rehearing with suggestion for rehearing en banc. All the judges on the original panel have voted to deny the petition, and none of the active judges have requested a vote on the suggestion for rehearing en banc. The petition is therefore DENIED.

STATUTORY PROVISION INVOLVED

26 U.S.C. § 162(a) provides in pertinent part:

> IN GENERAL – There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of	)	
COMARK CABLE FUND III d/b/a CCI CABLEVISION,	)	
Complainant	)	Filed No. E-84-1
v.	)	
NORTHWESTERN INDIANA TELEPHONE COMPANY, INC.	)	
and	)	
NORTHWEST INDIANA CATV, INC. d/b/a NORTHWESTERN INDIANA CABLEVISION, successor to RHYS MUSSMAN d/b/a NORTHWESTERN INDIANA CABLEVISION,	)	
Defendants	)	

MEMORANDUM OPINION AND ORDER AND NOTICE OF APPARENT LIABILITY FOR FORFEITURE

Adopted March 12, 1985 : Released March 18, 1985

By the Commission:

1. Comark Cable Fund III d/b/a CCI Cablevision (CCI), a former operator of a cable television system in Hebron, Indiana, seeks a cease and desist order against Northwestern Indiana Telephone Company, Inc. (NITCO) and Northwest Indiana CATV, Inc., d/b/a Northwestern Indiana CableVision (Northwest Cable) for conduct allegedly in violation of the Communications Act and the Commission's telephone/cable television company cross-

ownership rules. For reasons fully discussed below, we find that Defendants and principals thereof have entered into agreements in violation of such rules, and that NITCO has constructed cable television distribution facilities without prior Commission authorization in violation of Section 214(a) of the Communications Act of 1934, as amended.[1] Therefore, we order NITCO to divest itself of all prohibited facilities and terminate prohibited affiliations with Northwest Cable. We are also issuing a Notice of Apparent Liability for Forfeiture against NITCO.

I. Background

2. On October 12, 1983, CCI initiated this proceeding by filing a complaint, pursuant to Section 208 of the Communications Act, against NITCO and Northwest Cable's predecessor, Rhys Mussman d/b/a Northwestern Indiana CableVision. The gravamen of CCI's complaint is that defendants are affiliated companies engaged in discriminatory and anticompetitive conduct in violation of the Act and the Commission's telephone/cable television company cross-ownership rules. More particularly, CCI alleged, *inter alia*, that NITCO was constructing and operating a cable television system in Hebron and constructing a cable television system in DeMotte, Indiana, both within its telephone service area, without Commission authorization and to CCI's detriment, in violation of Sections 202(a) and 214(a) of the Act and Section 63.54 of the

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[1] 47 U.S.C. §214(a), provides, in pertinent part, that no carrier shall construct any interstate line without prior Commission authorization.

Commission's Rules.[2] In addition to seeking the issuance of an order to show cause why NITCO and Northwest Cable (Defendants) should not be ordered to cease and desist from such alleged violations, CCI also seeks compensatory and punitive damages and attorney fees.

3. On November 28, 1983, Defendants timely filed separate answers denying such violations and further denying that they were affiliated within the meaning of

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[2] Section 202(a) of the Act, 47 U.S.C. §202(a), provides as follows:

> It shall be unlawful for any common carrier to make any unjust or unreasonable discrimination in charges, practices, classifications, regulations, facilities, or services for or in connection with like communication service, directly or indirectly, by any means or device, or to make or give any undue or unreasonable preference or advantage to any particular person, class of persons, or locality, or to subject any particular person, class of persons, or locality to any undue or unreasonable prejudice or disadvantage.

Section 63.54 of the Rules, 47 C.F.R. §63.54 proscribes, *inter alia*, the furnishing of cable television service to the viewing public by any telephone company within its telephone service area, either directly, or indirectly through an affiliated company. A telephone company also may not furnish pole space or other rental arrangements to an affiliated company where such arrangements would be used to provide cable television services within the telephone company's telephone service area. Affiliation in this connection is broadly defined to include "any financial or business relationship whatsoever by contract or otherwise, directly or indirectly, between the carrier and the customer, except only the carrier-user relationship." Note 1(a). *See* Cross-Ownership Rules, 82 FCC 2d 254, 264 (1980). *Cf.* Section 613 of the Cable Communications Policy Act of 1984, Pub. L. No. 98-549, Oct. 30, 1984.

Section 63.54 of the Rules.[3] They asserted that Rhys G. Mussman resigned his position as Executive Vice President of NITCO on December 31, 1982 and that all dealings between Defendants since then concerning the construction and operation of Northwest Cable or its predecessor were at "arm's length" and with fair compensation to NITCO.

4. On December 12, 1983, in addition to its reply to Defendants' answers, CCI filed a motion seeking an order to make answers more definite. In addition, or in the alternative, CCI sought an order authorizing the use of immediate discovery prior to designation of its complaint for an adjudicatory hearing. By *Memorandum Opinion and Order*, unpublished, released April 18, 1984, CCI's motion was denied insofar as it sought full discovery prior to designation. However, NITCO was directed to file an amended answer providing, certain additional information. Additional information was also requested of Northwest Cable. Separate amended answers were timely filed by Defendants on May 18, 1984.[4]

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[3] NITCO originally had been directed to either satisfy or answer CCI's complaint within 20 days. However, over CCI's objections, Defendants were granted an additional 10 days within which to file their answers because of our desire to have a full record before us. *See Memorandum Opinion and Order*, unpublished, released November 17, 1983.

[4] Also before us are CCI's Reply to the Amended Answers filed June 11, 1984, a Consolidated Motion for Leave to File Responses to that reply, and separate responses to the reply filed by Defendants on July 9, 1984; and CCI's Opposition to the motion, filed July 19, 1984. Because CCI's Reply presented new factual evidence for consideration, Defendants' motion is granted.

II. Findings of Fact

A. The Parties

5. CCI is a Florida limited partnership that held non-exclusive franchises for cable television systems in the towns of Hebron and DeMotte, Indiana. It has constructed a cable television system in Hebron. Service was commenced in December, 1982. CCI served about 375 subscribers in Hebron in October, 1983 when it filed its complaint. It subsequently sold its Hebron system.[5]

6. NITCO is an Indiana corporation and a communications common carrier providing telephone exchange services in Hebron, DeMotte, Lakes of the Four Seasons, and Mt. Ayr, Indiana.[6] It is a closely held family corporation controlled by Robert G. Mussman, its President, Chairman and one of three directors. Mr. Mussman owns 1050 of the company's 1100 shares of stock. The remaining 50 shares are owned by R. Gerald Mussman,[7] a director of the company and its Vice President. The third director and the company's secretary-treasurer, Myrtis E. Mussman, is Robert G. Mussman's wife. Until his resignation as Executive Vice President on December 31, 1982, their son, Rhys G. Mussman, was the highest salaried employee in the company after Robert G. Mussman. He continues as a consultant to NITCO and his fees for 1983

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[5] Complaint at 2; letter to the Commission from Robert E. Levine, counsel for CCI, dated November 19, 1984.

[6] NITCO is also the radio licensee of station KSJ622 in the Public Land Mobile Service.

[7] R. Gerald Mussman and Rhys G. Mussman are different individuals.

roughly equalled or exceeded his salary prior to his departure from the company as an employee. In his capacity as Executive Vice President, Rhys G. Mussman conducted cable television pole attachment negotiations with CCI's predecessor-in-interest, Telecom Services, Inc., during the last quarter of 1982.[8]

7. Northwest Cable is an Indiana corporation with cable television systems in the towns of Hebron and DeMotte, Indiana and Lakes of the Four Seasons, a planned residential development in unincorporated portions of Lake and Porter Counties, Indiana.[9] It received non-exclusive franchises for cable television systems from Hebron, Lakes of the Four Seasons Property Owners Association, Inc. (an Indiana not-for-profit corporation), and DeMotte on or about April 26, May 23, and August 1, 1983, respectively. Prior to its incorporation on April 4, 1983, Northwest Cable was operated as an individual proprietorship by Rhys G. Mussman, under the name

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[8] *Id.* at 3, 17-18; NITCO Answer at 1; NITCO Amended Answer at 6, 11, 13, 18, Exh. 16 at 93A; Reply to amended answers at 3-4; Response to reply to amended answers at 17, n.4.

[9] Northwest Cable has an application pending (FCC File No. CAR-22666-01) seeking authority to construct a station in the Cable Television Relay Service (CARS) to relay television signals via microwave radio from Hebron to DeMotte and Lakes of the Four Seasons, Indiana. CCI has filed a petition to deny such application. As of May 17, 1984, Northwest Cable represented that it had approximately 500 homes wired for service in the Four Seasons community, that the construction of its cable system at DeMotte was "nearing completion", and that it would begin service to the public in DeMotte as soon as the CARS facilities were authorized and constructed. Opposition to Petition to Deny filed May 22, 1984, at 11-12.

Northwestern Indiana CableVision. It continues to operate under that name as a corporation. Rhys G. Mussman, Robert Mussman's son, serves as its president and its sole officer, director and shareholder. The company currently has three employees, one of whom was formerly NITCO's plant engineer.[10]

B. Agreements between Defendants or their principals

8. Several oral agreements were entered into between Defendants or principals thereof after Rhys G. Mussman's resignation as Executive Vice President of NITCO and while he continued as a consultant to the company. None of the agreements were reduced to writing until well after CCI filed its complaint. A consulting agreement between NITCO and Rhys Mussman never has been reduced to writing. The agreements are described below.

9. *Construction of Hebron cable television system.* In 1983, NITCO constructed a cable television system in Hebron for Northwestern Indiana CableVision pursuant to an oral agreement. The value of this construction was in excess of $70,800. A written contract for the maintenance of such system and construction of new lines was entered into on December 16, 1983 to become effective January 1, 1984.[11]

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[10] Northwest Cable answer at 1, 3, 10; amended answer at 2, 9, 11-12, Exh. 8, 11, 12, 13 at Attachment G.

[11] NITCO amended answer at 7-8, Exh. 3.

10. *Attachment to NITCO poles in Hebron.* On December 16, 1983, NITCO and Northwestern Indiana CableVision also reduced to writing their prior oral agreement by which cable television facilities could be attached to NITCO's poles in Hebron. The agreement calls for attachments at an annual rate of $4.00 per pole.[12]

11. *Construction of DeMotte cable television system.* Robert G. Mussman, on behalf of NITCO, and Rhys G. Mussman, for Northwestern Indiana CableVision, also entered into an oral contract by which NITCO constructed a cable television system in DeMotte, Indiana. That contract was not reduced to writing until May 14, 1984.[13]

12. *Construction of Four Seasons cable television system.* An oral agreement by which NITCO agreed to construct a cable television system for Northwestern Indiana CableVision in the community of Lakes of the Four Seasons, Indiana similarly was not reduced to writing until May 14, 1984.[14]

13. *Attachment to NITCO poles in DeMotte and Lakes of the Four Seasons.* NITCO and Northwestern Indiana CableVision's agreement for pole attachments in Hebron was amended on May 14, 1984 to apply also to NITCO's poles in DeMotte and Lakes of the Four Seasons.[15]

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[12] *Id.* at Exh. 4.

[13] *Id.* at Exh. 1.

[14] *Id.* at Exh. 2.

[15] *Id.* at Exh. 4.

14. *Lease of property at 301 North Washington Street.* Rhys Mussman, through Northwestern Indiana CableVision, has leased property, including office space, at 301 North Washington Street in Hebron from his father, Robert G. Mussman and his mother, Myrtis E. Mussman. The parties operated under an oral lease from January 1983 until May 14, 1984 when the lease was reduced to writing. The property is immediately adjacent to NITCO's headquarters address at 205 North Washington Street, which property also is owned by Robert and Myrtis Mussman.[16]

15. *Sublease of property at 205 North Washington Street.* On May 1, 1984, Northwest Cable entered into a written agreement with NITCO to sublease a portion of the real estate surrounding the commercial office building at 205 North Washington Street which NITCO leased from Robert and Myrtis Mussman.[17] Northwest Cable's earth station antennas and other cable television equipment are located on the property so subleased, which includes a cement concrete pad constructed in April 1982 for a satellite television antenna also erected at that time.[18]

16. *Consulting Agreement.* NITCO has employed Rhys G. Mussman as a consultant since his resignation. Such agreement has never been reduced to writing. Mr.

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[16] *Id.* at Exh. 5, 6; complaint at Exh. D-1.

[17] NITCO amended answer at Exh. 5.

[18] *See* excerpts from transcripts of minutes of April 28, 1982 meeting of the Board of Trustees of Hebron, Indiana, attached as Exhibit A to CCI's consolidated reply to amended answers, at 4-5 and attachments.

Mussman has received more than $57,000 from NITCO in consulting fees since 1983 from which social security and income taxes have been withheld. He continues to be covered by NITCO insurance and pension plans and has been provided with office furnishings within NITCO's headquarters offices. His consulting fees from NITCO for 1983 amounted to about the same sum as or exceeded his salary from NITCO for 1982. Rhys G. Mussman has not drawn any salary from his own company, Northwest Cable.[19]

17. *Financial guarantees.* Robert G. Mussman and his wife personally guaranteed six bank loans to Northwest Cable in the current principal amount of approximately $450,000.[20]

18. Robert G. Mussman also personally guaranteed the obligations of Rhys Mussman to the Town of Hebron under an indemnity agreement of April 26, 1983 in connection with litigation Rhys Mussman initiated against CCI and the town, among others. It appears that Rhys Mussman's efforts to reexecute the agreement or otherwise assure the town of his financial ability to adequately undertake his cable television commitments without Robert Mussman's personal guarantee, have been unavailing.[21]

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[19] NITCO amended answer at 9-11, 13, 14, Exh. 16 at 93A.

[20] NITCO amended answer at 18 and Exh. 11.

[21] Northwest Cable amended answer at Exh. 14; NITCO's answer at 6-7.

C. Special franchise provisions

19. Section 2(k) of the franchise granted Rhys Mussman on April 26, 1983 by the Town of Hebron provides:

> "Gross Subscribers Revenues" shall include any and all compensation or receipts derived by Grantee from the operation of the Cable Television System authorized herein, but shall not include any refunds or credits made to subscribers or any taxes imposed on the services furnished by Grantee, and *shall also not include consideration received directly or indirectly by Northwestern Indiana Telephone Company, Inc. from subscribers or users in payment of the receipt of signals other than broadcast television, radio or original cable cast programming of the Franchisee, whether for "Facsimile" transmission, "return" or "subscriber response communication", and whether or not transmitted encoded or processed to permit reception by only selected subscribers.* (emphasis added).

According to CCI, its Hebron franchise agreement does not contain a similar reference to "consideration received directly or indirectly" by NITCO.[22]

20. Section 22 of the franchise granted Northwest Cable or its predecessor on May 23, 1983 by the Lakes of the Four Seasons Property Owners Association, Inc. provides, in part:

> The term 'annual gross operating revenues' used herein shall not include any revenues received by Northwestern Indiana Telephone

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[22] *See* CCI's reply at 4-5.

> Company for services it may render to its customers within the franchise area. . . . [23]

D. Common use of Post Office Box

21. NITCO's business address, *i.e.*, 205 North Washington Street or P.O. Box 67 in Hebron, has been used commonly by NITCO and by members of the Mussman family. Mail addressed to that post office box has been delivered there by the local Post Office, including mail addressed to Rhys G. Mussman or Northwestern Indiana CableVision.[24] Also, mail sent to Rhys Mussman in Hebron with no address specified has been deposited in P.O. Box 67 by the local Post Office. Even though the proper address for Northwestern Indiana CableVision has been 301 North Washington Street since January 1983, P.O. Box 67 continued to be specified as Northwestern Indiana CableVision's address on correspondence delivered as late as April 1983.[25]

E. The Mussman family business connection

22. In his efforts to obtain cable television franchises from the towns of Hebron and DeMotte, Rhys Mussman did not hesitate to link himself with members

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[23] *See* Attachment G to Exhibit 13 of Northwest Cable's amended answer at 10-11. *See also* Attachment C to that exhibit.

[24] *See, e.g.*, letter 1982 to Rhys Mussman from the First National Bank, Valpariso, September 20, Exhibit 11 of the amended answer of Northwest Cable, at Exhibit J.

[25] *See, e.g.*, letter to Rhys Mussman from John Howard, April 19, 1983, Exhibit 11 of the amended answer of Northwest Cable at Exhibit A; NITCO amended answer at 14-15.

of the Mussman family, especially his father, who had ties to the communities and their affairs for many years. In his November 25, 1980 proposal to the DeMotte Town Board to build and operate a cable television system, Rhys Mussman noted that he was currently "Executive-Vice President of the Northwestern Indiana Telephone Company Inc. . . . "[26] At an April 28, 1982 meeting of the Town Board of Hebron, Rhys Mussman represented that "my father is the Secretary-Treasurer" of Northwestern Indiana CableVision.[27] When Hebron granted Northwestern Indiana CableVision a franchise on April 26, 1983, subsequent to both Rhys Mussman's resignation as NITCO's Executive Vice President and Northwest Cable's incorporation, Robert G. Mussman guaranteed Northwestern Indiana CableVision's obligations to Hebron under an indemnity agreement of the same date.[28] Rhys Mussman also linked Northwest Cable to his father in an August 1983 letter to the DeMotte Town Board to express his dismay that the town had not awarded an exclusive franchise to Northwestern Indiana CableVision but one also to Telecom Services, Inc., a competitor and CCI's predecessor-in-interest. In his letter, Rhys Mussman (who was less than 30 years old) said it seemed odd that the town had also awarded a franchise to an out-of-state company rather than award a single franchise to "*the person* who has been helping the community grow for *over*

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[26] Amended answer of Northwest Cable, Exh. 10 at unnumbered page 7.

[27] Exhibit A to reply to amended answers, at 6.

[28] *See* Northwest Cable amended answer, at Exh. 14.

forty years. . . . " (emphasis added).[29] Like Hebron, the Lakes of the Four Seasons Property Owners Association apparently also perceived a connection between Northwest Cable and NITCO and a need to distinguish between their revenues.[30]

III. Discussion and conclusions of law

A. The telephone/cable television company cross-ownership rules

23. In our Final Report and Order in Docket No. 18509,[31] we considered "the anomalous competitive situation" between cable television systems which are affiliated with the telephone companies and those with no such affiliation, which must rely on attachments to the telephone companies' poles to construct their systems.[32] We recognized that the entry by a telephone company, directly or through an affiliate, into the retailing aspects of cable television service in a community within which it furnished telephone service could lead to "undesirable consequences" and anticompetitive abuses because of the

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[29] *See* August 1, 1983 letter to DeMotte Town Board from Rhys G. Mussman, President, Northwestern Indiana CableVision, in Exh. 11 of Northwest Cable amended answer; see also Response of Northwest Cable to CCI's reply to amended answers, at 2.

[30] *See* paras. 19 and 20, *supra*.

[31] *Section 214 Certificates*, 21 FCC 2d 307, *recon. in part*, 22 FCC 2d 746 (1970), *aff'd sub nom. General Telephone Co. of the Southwest v. U.S.*, 449 F.2d 846 (5th Cir. 1971).

[32] *Id.* at 323.

telephone company's monopoly position over essential pole facilities within the community.[33] We concluded that:

> the public interest in modern and efficient means of communications would best be served by preserving, to the extent practicable, a competitive environment for the development and use of broadband cable facilities and services and thereby avoid undue and unnecessary concentration of control over communications media either by existing carriers or other entities. . . .

and adopted a policy barring "all telephone common carriers from furnishing [cable television] service to the viewing public in their operating territory except when, for good cause shown, a waiver of this policy is granted." We also precluded telephone common carriers from providing cable television service directly or indirectly to the viewing public by entering into pole rental agreements with their affiliates in communities where they provide telephone exchange service.[34] In adopting rules precluding a telephone company from providing cable television service within its telephone service area directly or indirectly through an affiliated company, we said we would "broadly interpret the concept of affiliation" and barred "any financial or business relationship whatsoever by contract or otherwise, directly or indirectly, between the carrier and [cable television system], except only the carrier-user relationship."[35]

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[33] *Id.* at 324.

[34] *Id.* at 325.

[35] *Id.* at 325-26 and 331.

24. Defendants' pleadings demonstrate that they were aware of the Commission's telephone/cable television cross-ownership prohibition prior to any cable system construction or other organizational activity.[36] Indeed, as early as April 28, 1982, Rhys Mussman was advised at a meeting of the Board of Trustees of the Town of Hebron that there had "been a lot of changes recently" in the telephone/cable television cross-ownership rules that he might "want to check into". Exh. A to reply to amended answers, at 5. Further, after being served with the subject complaint, Defendants also were placed on notice that they risked sanctions if they continued their cable television activities.[37]

25. Prohibited relationships include, *inter alia*, any person having a financial interest, including interests

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[36] NITCO and Northwest Cable answers, at 2.

[37] In April 1984, Defendants' attorney was cautioned that:

> any further construction and operation of cable television facilities by Northwest Indiana CATV, Inc. within NITCO's telephone service area without prior Commission authorization is at its peril and may be found to be in violation of the Commission's telephone/cable television company cross-ownership rules and subject to appropriate penalties under the Communications Act, 47 U.S.C. §151 *et seq.*, including divestiture.

Letter to David L. Nace dated April 18, 1984 from Chief, Enforcement Division, Common Carrier Bureau. Defendants' attorney also has been informally advised that action on Northwest Cable's CARS application (*see* n.9, *supra*) currently is being held in abeyance pending resolution of the instant complaint.

other than ownership, in both a carrier and its customer.[38] Here, Robert Mussman not only controls the telephone company but also guaranteed repayment of substantial bank loans made to his son's cable television company, as well as guaranteeing certain obligations of his son to the Town of Hebron in connection with cable television franchise litigation. Although NITCO never has undertaken any non-tariffed construction project of more than $100,000,[39] Robert Mussman's telephone company entered into oral contracts with his son's cable company to construct cable television systems in Hebron, DeMotte, and Lakes of the Four Seasons involving amounts in excess of that sum. Such contracts were not reduced to writing until well after the instant complaint was filed. We also note that the terms of the oral agreement under which Robert Mussman's company has paid his son substantial consulting fees has never been reduced to writing. Although NITCO purportedly employs Rhys Mussman as a consultant, his fees in 1983 equalled or exceeded his salary of 1982 as an employee. In addition, withholdings and benefits he receives while purportedly serving as a consultant are indicia of an employer-employee relationship, a conclusion bolstered by the fact that Rhys Mussman has earned no income in his purported role in the cable side of the family business. Furthermore, Rhys Mussman represented at public proceedings his father's participation in the cable enterprise. These facts, together with all of the other facts set forth in paras. 5-22, *supra*, lead to the conclusion that

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[38] 47 C.F.R. §63.54 at n.1(b).

[39] NITCO amended answer at 21.

NITCO and Northwestern Indiana CableVision, both before and after the latter's incorporation, have been, and continue to be, affiliated companies within the meaning of Section 63.54 of the Commission's Rules and that they are acting in contravention of the Commission's rules.[40]

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[40] Section 63.54, 47 C.F.R. §63.54, as amended, provides as follows:

(a) No telephone common carrier, subject in whole or in part to the Communications Act of 1934, shall engage in the furnishing of cable television service to the viewing public in its telephone service area, either directly, or indirectly through an affiliate owned by, operated by, controlled by, or under common control with the telephone common carrier.

(b) No telephone common carrier, subject in whole or in part to the Communications Act of 1934, shall provide channels of communications or pole line conduit space, or other rental arrangements, to any entity which is directly or indirectly owned by, operated by, controlled by, or under common control with such telephone common carrier, where such facilities or arrangements are to be used for, or in connection with, the provision of cable television services to the viewing public in the telephone service area of the telephone common carrier.

Note 1: (a) *As used above, the terms "control" and "affiliate" bar any financial or business relationship whatsoever* by contract or otherwise, directly or indirectly, between the carrier and the customer, except only the carrier-user relationship. (emphasis added)

(b) Examples of situations in which a carrier and its customer will be deemed to be controlled or having a relationship include the following,

26. Defendants' reliance upon cases concerning multiple ownership of broadcast and/or cable television interests and sections in Parts 73 and 76 of our rules is misplaced. Such cases are not controlling since the terms "control" and "affiliate" as used in Section 63.54 are much more broadly defined than are those or similar terms in other Commission rules which do not involve common carrier issues. The terms "control" and "affiliate", as defined in Note 1(a) to Section 63.54, preclude NITCO from affiliating itself directly or indirectly with any company owned by, operated by, controlled by, or under common control with it. Also precluded is "any financial or business relationship whatsoever . . . " other than the ordinary telephone company relationship with subscribers to its telephone services. *Cf.*, 47 C.F.R. §63.08(a).

27. Defendants also seek to justify their conduct by distinguishing certain cases in which the Commission disregarded the corporate facade of allegedly independent companies in order that the purpose of the Act and its regulations not be frustrated. They argue that they are independent companies dealing at arm's length and that there is no warrant for the Commission "to pierce their

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> among others: where one is the debtor or creditor of the other (except with respect to charges for communication services); where they have a common officer, director, or other employee at the management level; where there is any element of ownership or other financial interest by one in the other; and where any party has a financial interest in both.

See also Cross-Ownership Rules, *supra*, 82 FCC 2d at 264.

corporate veils" as was done in the cases of *Dimension Cable TV, Inc.*, 25 FCC 2d 520 1970), *recon. denied*, 27 FCC 2d 43 (1971); *TeleCable Corporation*, 19 FCC 2d 574 (1969); and *Manatee Cablevision, Inc.*, 22 FCC 2d 841 (1970), *vacated on other grounds*, 35 FCC 2d 639 (1972). We note that such cases were designated for hearing before our telephone/cable television company cross-ownership rules were adopted. After adoption of these rules, there no longer is any need to designate cases for evidentiary hearings to determine whether telephone and cable television companies are under common business or financial control or whether they are nonaffiliated and truly independent of one another. Since 1970, when the rules were adopted, *any* financial or business relationship by a telephone company with an affiliated cable television system within its service area (other than the ordinary telephone customer relationship) is prohibited unless a waiver of the rules has been granted. Cable television service offered by an affiliated system is considered cable television operation by a telephone common carrier and is subject to the requirements of the rules "without any further necessity of piercing the corporate veil."[41] In light of the prohibition, NITCO would have had to obtain a waiver of such rule, and grant of authority pursuant to Section 214(a) of the Act, (*see* para. 29, *infra*) before

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[41] *Section 214 Certificates, supra*, 22 FCC 2d at 751. *See also Armstrong Utilities, Inc.*, 25 FCC 2d 385, 388 (1970); *D&E Cable TV, Inc.*, 28 FCC 2d 24 (1971).

entering into pole attachment and other agreements with Northwestern Indiana CableVision.[42]

28. Since we have found that Defendants are affiliated companies within the meaning of Section 63.54 of our rules and that they have, without prior Commission authorization, entered into pole rental and other agreements with respect to construction and maintenance of cable television system facilities in Hebron, DeMotte and Lakes of the Four Seasons, Indiana, communities in which NITCO provides telephone exchange service, we conclude that NITCO has violated, and continues to violate the rule. Accordingly, we are issuing a Notice of Apparent Liability for Forfeiture against NITCO in the amount of $20,000 in accordance with Section 503(b) of the Act, 47 U.S.C. §503(b), for willful and repeated violations of Section 63.54 of our rules.[43]

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[42] Section 63.56(a), 47 C.F.R. §63.56(a), as amended, provides as follows:

> In those areas where cable television service demonstrably could not exist except through a cable television system owned by, operated by, controlled by, or affiliated with the local telephone common carrier, or upon other showing of good cause, the provisions of §§63.54 and 63.55 may be waived, on the Commission's own motion or on petition for waiver, if the Commission finds that the public interest, convenience and necessity would be served thereby.

See also CATV Service Area Standard, 86 FCC 2d 983, 991 (1981).

[43] According to data in its annual reports, as filed with the Indiana Public Service Commission, we note that NITCO's net income after taxes for the years 1981, 1982 and 1983 exceed $372,000, $475,000, and $756,900 respectively. NITCO's 1983 earnings equated to a return on equity in excess of 18%. *See* Exh.

B. Section 214(a) certification

29. In *Section 214 Certificates, supra,* we properly disregarded the legal facade of separate corporate identities when the purpose of Section 63.54 of our rules would otherwise have been frustrated. Similarly, based upon undisputed facts of record here before us, the separate corporate identities of Defendants must be disregarded in order to preserve the integrity of the statutory scheme embodied in Section 214(a) of the Act.[44] It has long been settled that construction of cable facilities for transmission of broadcast television signals by a carrier constitutes construction of part of an interstate channel of communication requiring our prior certification under Section 214 of the Act that the present or future public convenience and necessity requires or will require such construction.[45] The fact that the cable television distribution facilities may be owned and operated by the cable television system, rather than leased from the telephone company, does not necessarily mandate a different result. *See Dimension Cable TV, Inc., supra,* 27 FCC 2d at 48.[46] While we have granted blanket authority to telephone

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15-17 to NITCO's amended answer, at 13, line 56, col. (c) and 16, line 37, col. (b).

[44] *See General Telephone Co. of Southwest v. U.S., supra,* 449 F.2d at 855.

[45] *General Telephone Company of California,* 13 FCC 2d 488, *recon. denied,* 14 FCC 2d 695 (1968), *aff'd.,* 413 F.2d 390, *cert. denied,* 396 U.S. 888 (1969). *See also C&P Tel. Co.,* FCC 85-48, released January 30, 1985, at para. 16.

[46] *See also General Telephone Company of the Southwest v. United States,* 449 F.2d 846 (5th Cir. 1971).

companies to construct cable television distribution facilities *outside* of their exchange telephone service area, construction of such facilities by a telephone company *within* its exchange telephone service area for an affiliated cable system requires advance certification pursuant to Section 214(a) of the Act in order to, *inter alia*, ascertain compliance and enforce our cross-ownership rules before such construction may be lawfully undertaken.[47] On the basis of undisputed facts of record before us, we conclude that NITCO's construction of cable television systems for Northwestern Indiana CableVision, its affiliated cable television system, in Hebron, DeMotte and Lakes of the Four Seasons, Indiana without having received prior authorization violated Section 214(a) of the Act.

C. Section 202(a) discrimination

30. We long have been concerned with unlawful discrimination vis-a-vis independent cable television companies by telephone common carriers with control over poles required for the construction of such cable systems.[48] Indeed, it was because of such concerns and the potential for anticompetitive abuses that we ultimately adopted our telephone/cable television cross-ownership rules. CCI has alleged that NITCO has engaged in anticompetitive conduct by offering more favorable terms and conditions for pole attachment to its affiliated company, Northwestern Indiana CableVision,

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[47] *Section 214 Authorization*, 98 FCC 2d 355, 356 (1984), at n. 3.

[48] *See, e.g., Warrensburg Cable, Inc.*, 67 FCC 2d 662 (1978) and cases cited therein at 667.

than to its potential competitor for wideband cable distribution facilities, CCI. NITCO's conduct, in this regard, is alleged to be in violation of Section 202(a) of the Act.[49] In view of the actions ordered herein based on violations of Section 214(a) of the Act and Section 63.54 of our cross-ownership rules, we do not believe it necessary to reach CCI's contention that NITCO's conditions for attaching its poles are unreasonably discriminatory in violation of Section 202(a) of the Act.[50]

D. Liability for damages

31. As previously noted, in addition to a cease and desist order, CCI also seeks compensatory and punitive damages as well as attorney fees.[51] Having determined

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[49] *Cf. Better T.V., Inc. of Dutchess County, New York*, 31 FCC 2d 939, 966-67 (1971); *Warrensburg Cable, Inc.*, 67 FCC 2d 662, 667-72 (1978).

[50] We concluded, prior to enactment of Section 224 of the Act, that we lacked regulatory jurisdiction over telephone company activity that constituted simply rental of available space on utility poles. *California Water and Telephone Co.*, 64 FCC 2d 753 (1977). Under Section 224 of the Act, 47 U.S.C. §224, the Commission has authority to resolve disputes concerning alleged unreasonable conditions for attaching utility poles by cable television system operators. CCI did not seek to invoke such jurisdiction in its complaint.

[51] We have no power to award attorney fees and that request will be denied. *Strouth v. Western Union*, 70 FCC 2d 506, 511, 567 (1978); *See also Illinois Bell Telephone Co.*, FCC 80 M-181, released January 30, 1980, 46 R.R. 2d 1449 (1980) and cases cited therein. CCI also has not shown that we have authority to award punitive damages and that request too will be denied. *See Jean Gilhart v. The Chesapeake & Potomac Telephone Company of*

that NITCO has violated Sections 214(a) of the Act and 63.54 of our rules and that it is therefore subject to the damage provisions of Section 206 through 209 of the Act,[52] we find that CCI is entitled to any consequential damages it can establish. The parties are encouraged to negotiate a reasonable and mutually agreeable settlement as to the amount of damages to which CCI may be entitled and to otherwise reach an acceptable resolution of this dispute. We expect the parties to promptly undertake good faith efforts to negotiate such a settlement and to report the results back to us in due course. Should they notify us that such efforts have failed, the Chief, Common Carrier Bureau, will determine such further actions as he deems necessary to resolve the issue.

IV. Conclusion and Ordering Clauses

32. Having found that NITCO and Northwest Cable are affiliated companies within the meaning of Section 63.54 of our rules and that they have, without prior Commission authorization, entered into pole rental and other agreements with respect to construction and maintenance of cable television system facilities, in continuing violation of such rule, we are issuing a Notice of Apparent Liability for Forfeiture against NITCO. Furthermore,

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Maryland, Inc., unpublished, released October 2, 1984 at para. 5 (File No. E-83-21).

[52] Such sections provide, *inter alia*, for the recovery of damages before either the Commission or a district court of the United States of competent jurisdiction when a carrier does any thing prohibited by the Act or omits to do any thing required by the Act.

because Defendants failed to obtain the necessary authorizations pursuant to Section 214(a) of the Act and 63.56(a) of our rules to construct and operate cable television systems in Hebron, DeMotte, Lakes of the Four Seasons, Indiana and any other areas in which NITCO provides telephone exchange service, NITCO shall, in the absence of such authorizations, be required to divest all facilities and terminate all affiliations between NITCO and Northwest Cable prohibited by Section 63.54.[53] NITCO will be directed to file within 40 days from the release of this order (a) its proposals to comply with our decision herein[54] including arrangements to minimize any interruption of cable television service to subscribing members of the public; and (b) the results of Defendants' efforts to negotiate a settlement with CCI with respect to CCI's claims for actual consequential damages.

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[53] Defendants have been on notice that their actions might contravene the Commission's telephone/cable television company cross-ownership rules and that they might be required to divest themselves of the subject cable television system distribution facilities. *See* para. 24, *supra*. Defendants thus proceeded at their peril and cannot now be heard to complain should the divestiture ordered herein be required to preserve the integrity of the statutory scheme, including Section 613(b) of the Cable Communications Policy Act of 1984, and Commission policy decisions and rules. *Cf., Lake Telephone Co., supra*, 41 FCC 2d at 338-39, and *Fort Mill Telephone Co., supra*, 25 FCC 2d at 752-53, where we conditioned the grant of temporary authority to continue certain telephone company operations upon their divesting themselves of all interests in cable television service to the viewing public within their service areas.

[54] Such prohibited affiliations include, but are not limited to, the financial guarantees, consulting agreement, and leases referred to in paras. 14-18, *supra*.

33. In addition, we caution NITCO and Northwest Cable that, having found them in violation of the Act and our rules, we have legal grounds for directing Defendants to show cause why a cease and desist order should not be directed against them prohibiting NITCO from any further construction of cable television distribution facilities and any further leasing of pole space to Northwest Cable for operation of cable television distribution facilities in Hebron, DeMotte, and Lakes of the Four Seasons without prior Commission authorization.[55] We will not hesitate to do so should Defendants undertake any additional unlawful construction or commence commercial cable television service to subscribers in Hebron, DeMotte, or Lakes of the Four Seasons who are not currently receiving such service. Further, we are also referring this matter to the Department of Justice under Sections 401 and 502 of the Communications Act for whatever action it may deem appropriate.

34. Accordingly, IT IS ORDERED, That, pursuant to Sections 4(i), 4(j), 202(a), 208, 214(a), 314 and 411(a) of the Communications Act, 47 U.S.C. §154(i), 154(j), 202(a), 208, 214(a), 314 and 411(a), Defendants' motion to dismiss the complaint in this proceeding IS DENIED;

35. IT IS FURTHER ORDERED, That Defendants' motion for leave to file a response to the reply to their amended answers IS GRANTED;

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[55] *Cf. Ashtabula Cable TV, Inc.*, 17 FCC 2d 113, *recon. denied*, 18 FCC 2d 193 (1969); *Lake Telephone Co.*, 41 FCC 2d 335 (1973); *Fort Mill Telephone Company*, 25 FCC 2d 748 (1970), *temporary authority extended*, 31 FCC 2d 867 (1971).

36. IT IS FURTHER ORDERED, That Northwestern Indiana Telephone Company, Inc. SHALL TERMINATE any affiliation with Northwest Indiana CATV, Inc. prohibited by Section 63.54 of the Commission's Rules, 47 C.F.R. §63.54, AND DIVEST any facilities prohibited by Section 63.54 by no later than six (6) months from the release of this Order, unless the Commission has granted appropriate waivers of Section 63.54 of its rules prior to that time;

37. IT IS FURTHER ORDERED, That, no later than 40 days form the release of this order, Defendants SHALL MAKE the filing specified in paragraph 31 herein;

38. IT IS FURTHER ORDERED, That complainant's claims for attorney fees and punitive damages ARE DENIED;

39. IT IS FURTHER ORDERED, That the parties SHALL UNDERTAKE good faith efforts to negotiate a settlement of complainant's claims for damages;

40. IT IS FURTHER ORDERED, That the Chief, Common Carrier Bureau, will determine what further actions, if any, should be initiated should the parties report that they have been unable to resolve the damage claims herein;

41. IT IS FURTHER ORDERED, That the complaint of Comark Cable Fund III, d/b/a CCI Cablevision, IS GRANTED to the extent indicated herein, and otherwise IS DENIED.

42. IT IS FURTHER ORDERED, pursuant to Section 503(b) of the Communications Act of 1934, as amended, 47 U.S.C. §503(b), and Section 1.80 of the Commission's

Rules and Regulations, 47 C.F.R. §1.80, That Northwestern Indiana Telephone Company, Inc. IS HEREBY NOTIFIED of an Apparent Liability for Forfeiture in the amount of $20,000 for its willful and repeated violations of Section 63.54 of our Rules by furnishing pole space and other rental arrangements within its telephone service area to Northwest Cable without authorization pursuant to 47 C.F.R. §63.56(a) to engage in such activities; and for its willful and repeated violations of 47 U.S.C. §214(a) by constructing distribution facilities for cable television systems in Hebron, DeMotte, and Lakes of the Four Seasons, Indiana without the requisite prior authorization of the Commission having been obtained.

43. IT IS FURTHER ORDERED, pursuant to Section 1.80(f)(3) of the Commission's Rules, 47 C.F.R. §1.80(f)(3), That NITCO shall, within thirty (30) days of the release of this notice, pay the full amount of the forfeiture in the manner provided for in Section 1.80(h) of the Rules or shall file a response showing why a forfeiture should not be imposed or should be reduced.[56]

44. IT IS FURTHER ORDERED, That the Secretary shall send by certified mail a copy of this Memorandum Opinion and Order and Notice of Apparent Liability for Forfeiture to Defendants' counsel, David L. Nace, Esq.,

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[56] Such a forfeiture amount should be booked to account 370, "Extraordinary income charges", which is a below-the-line account. 47 C.F.R. §31.370. NITCO's annual operating revenue for the years 1981 through 1983 was in excess of $250,000. *See* annual reports of NITCO filed with the Indiana Public Service Commision [sic], Exhibits 15-17 of NITCO's amended answer. Accordingly, NITCO is a Class A telephone company for accounting purposes. *See* 47 C.F.R. §31.01(a).

David L. Nace & Associates, One Thomas Circle, Washington, D.C. 20005.

45. IT IS FURTHER ORDERED, pursuant to Sections 401 and 502 of the Communications Act, 47 U.S.C. §§401 and 502, That the General Counsel shall refer this matter to the Department of Justice for whatever action it may deem appropriate.

FEDERAL COMMUNICATIONS COMMISSION

William J. Tricarico
Secretary

Supreme Court, U.S.
FILED
JUN 1 1998

No. 97-1652

In the Supreme Court of the United States

OCTOBER TERM, 1997

NORTHWESTERN INDIANA TELEPHONE COMPANY, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether, on the particular facts of this case, litigation costs incurred by petitioner Northwestern Indiana Telephone Company in contesting asserted violations of Federal Communications Commission rules were not deductible by it as ordinary and necessary business expenses under Section 162 of the Internal Revenue Code, 26 U.S.C. 162.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-12) is reported at 127 F.3d 643. The opinion of the Tax Court (Pet. App. 13-110) is reported at 71 T.C.M. (CCH) 2674.

JURISDICTION

The judgment of the court of appeals was entered on October 22, 1997. A petition for rehearing was denied on January 7, 1998 (Pet. App. 118-119). The petition for a writ of certiorari was filed on April 7, 1998. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner Northwestern Indiana Telephone Company (NITCO) is an independent telephone company that provides local telephone service in rural Indiana (Pet. App. 2). For more than 50 years, NITCO has been wholly owned by the family of Robert G. Mussman (*ibid.*). Mr. Mussman personally owned more than 95 percent of the stock. His son Rhys was employed by NITCO at various times and was also engaged in his own business venture (Pet. App. 3).

In 1983, Rhys incorporated Northwestern Indiana CableVision under the name NICATV to provide cable TV service in rural Indiana (Pet. App. 3). Although NITCO had no ownership interest in NICATV or its facilities, NITCO subsidized NICATV in a variety of ways (*ibid.*). For example, NITCO made regular payments to Rhys in amounts that approximated the salary he had earned when he was an employee at NITCO (Pet. App. 6). NITCO employees were also used to construct and operate the cable television system owned by NICATV in several locations (*ibid.*). And, in 1989, NITCO wrote off as "uncollectible" a debt of $122,000 owed to it by NICATV even though in July of that year Rhys sold NICATV to an unrelated third-party for $4 million (*ibid.*).

2. In October 1983, Comark Cable Fund III, a cable television competitor of NICATV, filed a complaint with the Federal Communications Commission in which it alleged that NICATV and NITCO were affiliated companies engaged in anticompetitive conduct in violation of the Communications Act of 1934 and FCC regulations (Pet. App. 3-4). The FCC agreed that NICATV and NITCO were "affiliated" compa-

nies and that the construction of cable facilities by NITCO for NICATV without prior FCC authorization violated Section 214(a) of the Communications Act of 1934, 47 U.S.C. 214(a) (Pet. App. 4). NITCO and NICATV were ordered by the agency to divest themselves of all cable television facilities constructed in violation of FCC rules, to terminate all improper affiliations and to negotiate a good faith settlement with Comark. The FCC also imposed a fine of $20,000 on NITCO (*ibid.*).

NICATV and NITCO reached a settlement with Comark in November 1985 but refused to comply with the divestiture order while the appeal from that order was pending. That refusal gave rise to an enforcement action by the United States and to a constitutional challenge to the agency rules by NITCO and Rhys (Pet. App. 4). After the FCC divestiture order was sustained on appeal (*ibid.*), Rhys sold NICATV to an unrelated third-party for $4 million in 1989 (*id.* at 6). In connection with these various lawsuits, NITCO incurred legal fees in excess of $700,000 for which it claimed an income tax deduction on its 1987-1989 returns (*id.* at 4).

3. The Internal Revenue Service disallowed the deductions claimed by NITCO for the legal fees incurred in the FCC litigation. Because these legal fees were incurred for the benefit of Robert Mussman, rather than for any business purpose of NITCO, the Service further concluded that the payment of the fees by the corporation represented a constructive dividend that constituted taxable income for Robert Mussman (Pet. App. 15-16).

4. The Tax Court upheld the Commissioner's determinations. The court concluded that the deductions claimed by NITCO for legal fees expended on

the FCC litigation should be disallowed under the "origin-of-the-claim" test adopted by this Court in *United States* v. *Gilmore*, 372 U.S. 39, 49 (1963) (Pet. App. 81). The Tax Court found, on the specific facts and circumstances of this case, that NITCO's transactions with NICATV and its improper affiliation with NICATV (which was the origin of the litigation and therefore of the litigation expenses) were not the result of an attempt by NITCO to enter the cable television business but were instead the result of Robert Mussman's decision to use his personal control over NITCO to subsidize his son's independent business efforts (Pet. App. 82). The court determined that the legal fees incurred by NITCO in challenging the FCC's rulings resulted from the personal activities of the owner, not the business activities of the corporation, and therefore did not constitute ordinary and necessary business expenses deductible under Section 162 of the Internal Revenue Code (*id.* at 84-86). The Tax Court sustained the determination that the payment of these fees represented a constructive dividend to Robert Mussman (*id.* at 87-88).

5. The court of appeals affirmed (Pet. App. 1-12). The court held that, in applying the origin-of-the-claim test established in *Gilmore*, the Tax Court had correctly examined whether the claim "grew out of the profit-making activity of NITCO" or was instead personal in origin (*id.* at 6). The court concluded that the litigation did not arise from the business or profit-making activities of NITCO but instead arose from Robert Mussman's exercise of his control over NITCO to subsidize his son's cable television business venture (*ibid.*). Because the origin of the claim was in the personal interests of the contolling shareholder rather than the business of NITCO, the court

concluded that the payment of the litigation fees by the corporation constituted a constructive dividend to Robert Mussman (*id.* at 7).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review of the inherently factual determinations of the courts below is not warranted.

1. Section 162(a) of the Internal Revenue Code allows a deduction for all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." 26 U.S.C. 162(a). Litigation expenses may be deducted as ordinary and necessary business expenses under Section 162(a) only when the litigation arises in connection with the profit-seeking activity of the taxpayer. *United States* v. *Gilmore*, 372 U.S. 39, 48 (1963). If the origin of the legal action is not in the business activity of the taxpayer, expenditures on legal fees are not deductible without regard to the motivation of the taxpayer or the potential effect of the litigation on the financial fortunes of the taxpayer. See *id.* at 49; *Anchor Coupling Co.* v. *United States*, 427 F.2d 429, 431 (7th Cir. 1970); *In re Collins*, 26 F.3d 116 (11th Cir. 1994).

In the present case, the litigation arose from a complaint filed with the FCC by a television competitor of NICATV that challenged the improper affiliation of NITCO with NICATV. The courts below correctly found, on the facts of this case, that the origin of that claim was not in the ordinary and necessary business activities of NITCO but was in the personal use of the assets of NITCO by its controlling shareholder to subsidize the efforts of a family member. Based upon

that factual determination, the courts correctly concluded that the legal fees incurred by NITCO were not deductible as ordinary and necessary business expenses under Section 162 of the Code (Pet. App. 6-7, 82-86).

As the courts below concluded, the involvement of NITCO in the business activites of NICATV was not part of any attempt by NITCO to expand its telephone business into the cable television business. The improper affiliation of NITCO and NICATV was the product of Robert Mussman's desire to assist the cable television business operated by his son Rhys. Although Mussman caused his corporation to expend resources to assist his son's business, NITCO did not stand to profit from the assistance it provided to NICATV. The transactions between NITCO and NICATV represented a gratuitous attempt by a father to use his corporation to enhance the business of his son (Pet. App. 6-7, 82-85). The detailed findings concurred in by both of the courts below do not warrant further review. See, *e.g.*, *Tiffany Fine Arts, Inc.* v. *United States*, 469 U.S. 310, 317-318 n.5 (1985).

2. Petitioners err in claiming (Pet. 12-13) that the court of appeals incorrectly focussed not on the origin of the claim against NITCO but on its motives in providing assistance to NICATV. Whether an expense is business-related within the meaning of Section 162 necessarily involves a determination whether a nexus exists between that expense and a profit-seeking activity of the taxpayer. See *United States* v. *Gilmore*, 372 U.S. at 48; *International Trading Co.* v. *Commissioner*, 275 F.2d 578 (7th Cir. 1960). The presence or absence of a profit motive is critical in determining whether the activity constitutes a trade or business for purposes of deductibility under

Section 162. The origin-of-the-claim test developed and applied by this Court in *United States* v. *Gilmore*, 372 U.S. 39 (1963), precludes a taxpayer from attributing a theoretical or subjective business motive to an inherently personal expense. As the courts below recognized in this case, however, it does not preclude an inquiry into the existence or absence of a profit motive for an activity that the taxpayer asserts is somehow connected to its business (Pet. App. 6).

Petitioners similarly err in contending (Pet. 14-17) that the court of appeals erroneously focussed on events that were irrelevant to, or that arose after the institution of, the litigation. In determining whether the origin of the claim that gave rise to the litigation expenses was business-related, it was proper for the courts below to examine the various transactions to determine whether NITCO's involvement with NICATV was part of its profit-seeking activity or was, instead, a personal attempt by Robert Mussman to assist his son Rhys in starting his own business. In making this inquiry, it is entirely permissible for a court to "inquire whether subsequent events are consistent with its judgment of the facts available in [the year in issue]." *Levin* v. *Commissioner*, 832 F.2d 403, 406 n.3 (7th Cir. 1987).

3. The inherently factual determination of the courts below does not, as petitioners incorrectly assert (Pet. 17-20), conflict with *Kopp's Co.* v. *United States*, 636 F.2d 59 (4th Cir. 1980), and *Dolese* v. *United States*, 605 F.2d 1146 (10th Cir. 1979), cert. denied, 445 U.S. 961 (1980). In *Kopp's Co.*, a corporation deducted amounts that it paid to settle an injury claim that stemmed from a car accident caused by the son of the sole shareholder who was driving a company car on personal use. The court allowed the com-

pany to deduct the amounts paid in settlement of the claim brought against it because its business and operations were directly threatened by the lawsuit. 636 F.2d at 61. In *Dolese* v. *United States*, a corporation was permitted to deduct a portion of the litigation expenses it incurred in defending a lawsuit filed against it by the wife of its sole shareholder in connection with their divorce. The court held that the litigation expenses were deductible because the lawsuit had placed the profit-making activities of the corporation in jeopardy. 605 F.2d at 1151-1152.

The facts and circumstances of the present case are, of course, significantly different from those involved in *Kopp's Co.* and *Dolese.* In both of those cases, the corporation was required to defend its ability to conduct its for-profit business. In the present case, by contrast, NITCO acted without any business purpose in providing gratuitous assistance to the activities of the son of its principal owner. Because NITCO had no ownership or profit interest in NICATV, it had no business reason to contest the divestiture order. It was only Mr. Mussman's son, Rhys, who stood to benefit if the divestiture order were overturned. The legal fees incurred by NITCO in contesting the divestiture order and the subsequent enforcement action instituted by the United States were designed to provide an economic benefit to the son of Mr. Mussman; they were not incurred for any business purpose of NITCO.* Because these legal fees did not constitute ordinary and necessary expenses of the trade or business of NITCO, the deduction of those expenses by the corporation was

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* It is also evident that NITCO did not spend $700,000 in legal fees to avoid the $20,000 fine imposed on it by the FCC.

properly disallowed by the courts below (Pet. App. 6-7, 82-88).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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MAY 1998